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FEDERAL INVOLVEMENT IN THE REGULATION OF THE INSURANCE INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

OCTOBER 22, 2003

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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WEDNESDAY, OCTOBER 22, 2003

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:30 a.m. in room SR–253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good morning. The purpose of today's hearing is to explore the effectiveness of the current state-based system of insurance regulation. In addition to examining the existing system of regulation, we will hear testimony about options for improving the current regulatory system, including initiatives to enhance state-level regulation and proposals to more actively involve the Federal Government in the regulation of the insurance business.

While the hearing topic may be straightforward, the question of how insurance should be regulated is complex and has long been debated. Over the decades, government officials, consumer groups, and industry participants have questioned whether the states should be the primary regulators of the insurance industry. Indeed, since the passage in 1945 of the McCarran-Ferguson Actflongwhich granted the states the exclusive power to regulate the business of insurance, the Federal Government has taken an increasingly active role in the regulation of the insurance industry.

Still, two major segments of the insurance industry remain almost exclusively within the jurisdiction of the states, namely property and casualty insurance and life insurance. Today's hearing will focus on the regulation of those two lines of insurance. As we continue to consider and debate the merits of whether the states or the Federal Government or some combination of the two should regulate the insurance industry, I would remind everyone that insurance is a unique business structured to protect both individuals and businesses from the risk of financial loss. Because insurance is a business, we need to make sure that the insurance companies are not overly burdened by unnecessary regulations.

Just as importantly, because insurance is so crucial to the day-to-day lives of Americans, we must also ensure that the interests of insurance consumers are protected, regardless of whether the states or the Federal Government regulate insurance.

In sum, our overarching purpose should be to strike a balance to ensure that consumers are well-protected and that insurance companies are not saddled with unnecessary regulation which can hinder their viability and jeopardize the very consumers we're seeking to protect.

I thank the witnesses for appearing before the Committee today, and I look forward to hearing their testimony. I'd like to turn to Senator Hollings, the Ranking Member of the Committee, who has had a longstanding and ongoing abiding interest in this issue.

STATEMENT OF HON. ERNEST F. HOLLINGS, U.S. SENATOR FROM SOUTH CAROLINA

Senator HOLLINGS. Thank you very much, Mr. Chairman, for your leadership and willingness to call this hearing, because my position comes over years and years of long experience.

Over 40 years ago as a Governor, I found in our insurance department that the bonds filed in order to qualify to do business in the great State of South Carolina were all just thrown down on the closet floor. The coupons have never been clipped, and literally 65 million was unaccounted for until we found it in the closet. We cleaned up the insurance department, and we have now, seated at the table, Mr. Ernest Csiszar, who is considered one of the outstanding state commissioners. So my complaint is not the state of South Carolina at the moment, but just generally speaking with respect to the states.

Beginning at the beginning, under Article I, Section 8, insurance is interstate commerce. There isn't any question about it, except those, of course, that are conducting business solely within the state. Otherwise, it's interstate commerce, found so by the U.S. Supreme Court, and accepted by McCarran-Ferguson, which, in the general sense, has not worked. Why hasn't it worked? Time and time again, seated up there over the past several years, they've come to us for product liability risk retention, they've come to us for flood and crop insurance, they've come to us for guarantee system with insurers, and, more recently, of course, for terrorism risk insurance. And every time they come, particularly with our experience in this Committee on product liability, the claim was that they couldn't even have a Little League baseball game because of the liability insurance of product liability, and everybody was going out of business, and they had to cancel the American Legion Series and everything else of that kind. We found out, rather, their losses were not on account of enormous product liability suits, but, on the contrary, their bad real estate investments. That was categorically, everybody agrees with that, and you don't hear any more about product liability before this Committee. They have moved on with that particular political move to so-called tort reform, malpractice, and now the asbestos case and class actions.

What happens is that you find out from the GAO report that they really leave a lot to be desired in the Administration, generally speaking, not necessarily, like I say, in my own state, but they've got all kind of practices. When the market is up, they run out and sell, sell, sell. They don't care about the premium, because they want the money to invest in the market, because they make way more money on the market than they do on the premium. And

then all of a sudden the market goes down, and then they say, "Ooh, malpractice, class actions, tort reform," and come running here. And, bottom line, I can't find out what is the truth, because I don't regulate it. Can you imagine having to come in on these emergency bases time and time and time again, where the Committee cannot find out what the truth is because we're not incident to their particular records and everything else, because we don't have Federal authority?

Well, we've got a good example, and a good example is out in California, where back in 1988 they passed Proposition 103 and all the companies that went back—turned back the premium—my particular bill doesn't call for any cancellation or reduction in the premiums, but they in Proposition 103 put it back some 20 percent. And they go in now and they have hearings and everything else before the rate increases. The insurance industry is thriving and growing and prospering in the state of California. And it is our hope that we can get in the interstate commerce, stop all of this gaming the system and then running to Washington saying, "Well, we want to deregulate, deregulate, deregulate," until they get into trouble with their tontine kind of practices, like Prudential did down in Florida. They sell a policy, gaming it on the stock market system and everything else of that kind. And then coming up to us, and then we can't find out what the truth is and everything else, and then desperately we give them money.

Let's get on and quit playing games and get into a Federal system, not any either/or where you game it again and where I can fix this particular insurance commissioner in state X—they can smile because they know exactly what I'm talking about. I've been in the game 50 years. And we used to get a necktie in the legislature in South Carolina, and then we'd all vote for the Commissioner.

[Laughter.]

Senator HOLLINGS. Thank you, Mr. Chairman.

[The prepared statement of Senator Hollings follows:]

PREPARED STATEMENT OF HON. ERNEST F. HOLLINGS,
U.S. SENATOR FROM SOUTH CAROLINA

For 150 years, insurance has been regulated by the states, and generally speaking, the industry has provided products that have enabled businesses and people to accept risks they otherwise would not. But there are trends developing that strike me as necessary to revisit the way the industry is regulated.

First, the insurance industry itself comes to Congress asking for bailouts and backstops with increasing regularity. Then, the industry turns around and asks for further deregulation, and even the ability to pick their regulator, when there are significant problems in the market that calls for more vigorous oversight. Of course, the insurance industry wants the regulator they get to pick to have a light hand so they can compete with banks in a climate that emphasizes short-term profits over long-term stability.

The GAO just weeks ago released a report analyzing the of market conduct regulation by the States. Market conduct regulation oversees how insurers treat consumers. The report said: "States generally have the systems and tools in place to regulate financial solvency. But market regulation is hindered by limited resources, a lack of emphasis on important regulatory tools, and the framework of the system itself, which requires individual states to oversee companies that operate in many states or nationwide. As a result, market regulation is currently based on overlapping and often inconsistent state policies and activities. While it provides some oversight, it may also place an undue burden on some insurance companies and, at times, may fail to adequately protect consumers."

Due to the limits of this fragmented, state-by-state regulation, no one stopped the poor investments made by insurance companies during the late 1990s that have helped drive up premium increases during the past three years.

The average policyholder may not know that insurance companies do not just profit on the difference between premiums collected and claims paid. Large portions of insurance company income is derived from investing premiums into stocks and bonds until they need the money for a large payout. An insurance company will often make more profit from investing the premiums of homeowner policies than on the margin between homeowner premiums and claims. By 2001, large insurance companies had more than half of their portfolios invested in corporate stocks and bonds.

This leaves insurance companies vulnerable to the stock and bond markets as never before. According to the Foundation for Taxpayer and Consumer Rights, just 10 companies lost $274 million on investments in Enron, WorldCom, Adelphia, Global Crossing and Tyco. State Farm Mutual Auto increased its level of corporate investment by 32 percent since 1994, but lost $60 million on WorldCom and $13 million Enron. Allstate lost $23 million in the first half of 2002 as the company shed its Tyco shares. USAA had 57 percent of its portfolio in the stock market, and lost $63 million in international energy and telecom investments.

It is no coincidence that we have seen insurance premiums rise as the stock and bond markets have lost value during the past couple years. When a customer receives a larger bill for homeowners insurance, it is not because the rate of homeowners claims has dramatically increased; it is because the insurance company is looking to recover the lost revenue from poor investment decisions. These companies reap the gains when investment returns are good, but then stick policyholders with the bill when investments go bad.

Some insurance executives and representatives of tort "reform" interest groups have even admitted to this trend. Victor Schwarz, General Counsel of the American Tort Reform Association, was quoted in the April 20, 2003, Honolulu Star-Bulletin as saying, "Insurance was cheaper in the 1990s because insurance companies knew that they could take a doctor's premium and invest it, and $50,000 would be worth $200,000 five years later when the claim came in. An insurance company today can't do that."

And Donald Zuk, CEO of Scpie Holdings, Inc., a leading malpractice insurer in California, told *The Wall Street Journal* in 2002 that recent premium rate increases by insurance companies were "self-inflicted" due to poor business management practices—not a spike in malpractice claims.

We need real Federal regulation, not "federal option charter" regulation, to correct these problems in the insurance industry. I have introduced S. 1373, the Insurance Consumer Protection Act of 2003 to do just that.

This bill will establish the Federal Insurance Commission, an independent commission established within the Department of Commerce. It will be comprised of five commissioners serving seven year terms, regulating property and casualty lines as well as life insurance. Workers compensation and state residual workers compensation pools will be excluded.

Under S. 1373, the McCarran-Ferguson antitrust exemption will be repealed. The Federal Insurance Commission will be the only regulator for interstate insurers. Insurers that only do business in the state in which they are domiciled (intrastate insurers) will be regulated by the states.

The Commission will be responsible for:

- Licensing and Standards for the Insurance Industry
- Regulation of Rates and Policies
- Annual Examinations and Solvency Review
- Investigation of Market Conduct
- Establishment of Accounting Standards

The Commission will be able to investigate the organization, business, conduct, practices and management of any person, partnership, or corporation in the insurance industry. The Commission will also create a central depository for insurance data for the purpose of studying the insurance industry.

In addition, under S. 1373 an independent office will be created within the Commission to receive complaints and reports about improper insurance industry practices from the public, and to represent consumers before the Commission. Consumers will have a right to challenge rate applications before the Commission.

The Commission will have the ability to issue cease and desist orders for practices that would place policyholders at risk, and to levy civil fines for violations of Commission regulations. Actions that require enforcement actions outside the scope of

the Commission's mandate will be referred to the proper agency. Criminal prosecutions will be handed to the Department of Justice.

Finally, a national guaranty corporation will be created to provide payment of life, property and casualty, and health claims when the insurer is unable to pay. The corporation will also be responsible for liquidating insolvent insurers.

Real Federal regulation as outlined in S. 1373 would protect consumers by giving them a voice in the setting of premium rates. Experiences with California's Proposition 103 legislation, which shares many of the same concepts as my bill, prove that involving the consumer in rate-setting will reduce insurance rates for consumers. Proposition 103 has saved California consumers billions of dollars via the prior approval regulatory structure it created. In the past two months alone, $62 million has been saved by doctors and homeowners due to rate challenges brought by consumers. This is a model that has worked in one of our largest and most populated states, and it should be a guidepost on how insurance regulation can provide consumer protection and stability.

Good actors in the insurance industry also would benefit from Federal regulation. Now, national insurance companies must navigate 50 different state laws regarding insurance, and must also navigate 50 different insurance commissions. Having one set of rules to govern the entire industry would create great efficiencies and competitive opportunities for these companies. By standardizing market conduct regulation standards, states could rely on examination results of other states, thus reducing the number of duplicative, expensive examinations companies now undergo.

There is no doubt real Federal regulation of insurance—not "federal option charter," which would allow each company to choose their regulator—would benefit the industry, the consumer, and the stability of our overall economy.

I consider the bill a starting point to spark discussions about how we can transform our fragmented oversight of the insurance industry into a streamlined, comprehensive review process that will better protect consumers and the free marketplace.

ATTACHMENT

U.S. SENATOR FRITZ HOLLINGS

NEWS

Contact: Andy Davis, (202) 224-6654

SUMMARY: Insurance Consumer Protection Act of 2003 (S. 1373)

Introduced by Sen. Hollings on July 8, 2003

Federal Regulation of Insurance: The Federal Insurance Commission will be an independent commission established within the Department of Commerce. It will be comprised of five commissioners serving seven year terms, regulating property and casualty lines as well as life insurance. Workers compensation and state residual workers compensation pools will be excluded.

Preemption: The McCarran-Ferguson antitrust exemption will be repealed. The Federal Insurance Commission will be the only regulator for interstate insurers. Insurers that only do business in the state in which they are domiciled (intrastate insurers) will be regulated by the states.

Powers of the Commission: The Commission will be responsible for:

- Licensing and Standards for the Insurance Industry
- Regulation of Rates and Policies
- Annual Examinations and Solvency Review
- Investigation of Market Conduct
- Establishment of Accounting Standards

Investigation and Data Collection: The Commission will be able to investigate the organization, business, conduct, practices and management of any person, partnership, or corporation in the insurance industry. The Commission will also create a central depository for insurance data for the purpose of studying the insurance industry.

Consumer Protection: An independent office will be created within the Commission to receive complaints and reports about improper insurance industry practices from the public, and to represent consumers before the Commission. Consumers will have a right to challenge rate applications before the Commission.

Enforcement: The Commission will have the ability to issue cease and desist orders for practices that would place policyholders at risk, and to levy civil fines for violations of Commission regulations. Actions that require enforcement actions outside the scope of the Commission's mandate will be referred to the proper agency. Criminal prosecutions will be handed to the Department of Justice.

Federal Guaranty Corporation: A national guaranty corporation will be created to provide payment of life and property and casualty claims when the insurer is unable to pay. The corporation will also be responsible for liquidating insolvent insurers.

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The CHAIRMAN. As I mentioned in my opening statement, Senator Hollings has a longstanding and abiding interest in this issue.

[Laughter.]

The CHAIRMAN. Senator Lautenberg?

STATEMENT OF HON. FRANK R. LAUTENBERG, U.S. SENATOR FROM NEW JERSEY

Senator LAUTENBERG. Thanks, Mr. Chairman, and we hope that we can keep Senator Hollings' standings on the issues after his— after he decides to become a golf pro or whatever else he intends.

[Laughter.]

Senator LAUTENBERG. But we're sure going to miss Senator Hollings, and we look with interest at his proposal here, although we're not quite prepared to say yes to that today.

And traditionally, insurance regulation has been left to the states, and I can tell you that the cost of insurance, especially auto insurance, is a huge issue for my constituents in New Jersey and others in the Northeast. The citizens of New Jersey, New York, and Massachusetts pay the highest premiums in the Nation for private passenger auto insurance. In 2001, the average premium nationwide was $718, but in New Jersey the average was $1,028, a substantial difference. According to a survey published by the National Association of Insurance Commissioners, New York drivers came in second, paying $1,015, and Washington, D.C., the drivers came in third, paying over a thousand dollars; they're $1,012. Massachusetts, it was the fourth, and they pay $936 for their automobile insurance, compared to, again, New Jersey, at $1,028. Seven of the top states, top ten states, with the highest auto insurance rates are located in the Northeast. Clearly, this is a problem. The question is whether the Federal Government ought to get involved. In New Jersey, our Governor has made auto insurance reform a priority. He's tackled the issue head on, signed the New Jersey Automobile Insurance Competition and Choice Act into law this past summer.

Now, the new law doesn't automatically cut premiums. Instead, it's intended to bring more insurers to the state by scaling back the regulations that some blame for forcing companies out of New Jersey. Competition presumably will drive premiums down. The new law tackles consumer issues, such as fraud, and allows drivers with good records to pay less than motorists with lots of tickets. But the bulk of the measure targets insurers.

The new law phases out the requirements that companies write policies for all drivers. It also streamlines the process for rate increases and scales back the rules requiring insurers to return excess funds to policyholders if the company averages more than 6 percent profit over 3 years.

As a direct result of auto insurance reform in New Jersey, the tide of insurers leaving the state seems to be turning. While more than 25 carriers have left New Jersey over the last decade, a major carrier, Mercury General Insurance, has become the first new insurer to enter this New Jersey market in 7 years. State Farm Insurance, which had previously announced that it intended to stop serving New Jersey consumers, has announced now that it plans to stay for four more years and has cut its rates by 4.1 percent,

and that puts $70, on average, back into the pockets of the policyholders.

The bottom line is that New Jersey appears to be headed in the right direction in dealing with its auto insurance woes. And I look forward to hearing from our friends, the witnesses, about what role, if any, the Federal Government should play in regulating property, casualty, and life insurers who write $700 billion in net premiums each year.

So, Mr. Chairman, once again, I thank you. The subject's an important one. I think this is kind of a first that this has been looked at.

The CHAIRMAN. Thank you, Senator Lautenberg.

The first from our panel of witnesses this morning is Mr. Ernst Csiszar, who's the Director of South Carolina's Department of Insurance, and Vice Chairman of the Executive Committee of the National Association of Insurance Commissioners; Mr. Tom Ahart, former President of Independent Insurance Agencies and Brokers of America; Mr. Craig Berrington, the Senior Vice President and General Counsel of American Insurance Association; Mr. Stephen E. Rahn, Vice President, Associate General Counsel, and Director of State Relations, Lincoln National Life Insurance Company; Mr. J. Robert Hunter, Director of Insurance in the Consumer Federation of America; and Mr. Douglas Heller, Senior Consumer Advocate, the Foundation for Taxpayer and Consumer Rights.

Welcome, Mr. Csiszar, we'll begin with you.

STATEMENT OF ERNST CSISZAR, VICE PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. CSISZAR. Thank you, Mr. Chairman, Senators, Senator Hollings, Senator Lautenberg, Senator Nelson.

The CHAIRMAN. You'll have to pull that microphone a little closer, if you don't mind.

Mr. CSISZAR. I'm delighted to be here, and let me begin by stating to Senator Hollings, that I think my Governor would embrace me with open arms if I could find $65 million for his budget in a closet somewhere in South Carolina, because we're—right now, we're hurting under budget shortfalls.

But let me begin by——

Senator HOLLINGS. He won't find it sleeping together.

[Laughter.]

Senator HOLLINGS. The Governor says in order to economize and balance the budget, that he wants state officials that go around on various missions to start sleeping——

Mr. CSISZAR. That's correct.

Senator HOLLINGS.—together.

[Laughter.]

Mr. CSISZAR. The "buddy system," we call it.

[Laughter.]

Senator HOLLINGS. You've got the wrong job.

[Laughter.]

The CHAIRMAN. You're the wrong type, Senator.

Mr. CSISZAR. Notice I have one of my associates back here with me, and she's female.

The CHAIRMAN. I don't know how much further we ought to push these——

[Laughter.]

Mr. CSISZAR. Let's stick to insurance regulations.

The CHAIRMAN.—budget-cutting measures.

Mr. CSISZAR. Let me begin by essentially recounting the fundamental purpose of insurance regulation. This purpose—this has been its purpose for the last 125 years. It has been a state-based system, but albeit all along the purpose has been consumer protection.

And the primary ways in which we pursue that objective at the state level is through two different means. One, because insurance is the type of product where your money comes first and the benefits, if any, sometimes come much later, so one way in which we regulate the industry is by way of solvency. We do financial analyses and reporting and disclosure and transparency. There is a separate accounting system, in fact, a more conservative accounting system than U.S. GAAP. It's known as statutory accounting. And we monitor the solvency of companies, largely to make sure that when the time comes for that benefit to be paid, that the companies are still around.

The second way in which we regulate insurance companies is through a market conduct process, and this is primarily driven by abusive practices, for instances, practices like redlining, for instance, other types of—for instance, the Prudential practice that you mentioned, Senator Hollings, a few years ago. We regulate that process through market conduct, market conduct exams, and a variety of laws on the books of states that deal with trade practices, unfair trade practices, discriminatory trade practices, and so on.

Under that umbrella of solvency regulation and market conduct regulation, the entities that we regulate are in the thousands, tens of thousands. They include the primary carriers, both on the life side, as well as the property and casualty side. These are the companies that sell directly to you, to the public. Certainly there is also a component of health insurance in there, but as I understand it today we're confining ourselves to property and casualty and life.

So there are thousands of companies on the primary side, there are not in the thousands, but in the dozens, of reinsurers that come under the umbrella of regulation, largely through what we call a credit-for-reinsurance system, so it's an indirect kind of regulation, by and large driven by the fact that you have sophisticated customer transactions. This like the wholesale market versus the retail market, in a way.

And, last, of course, we regulate the distribution system, be that through independent agents, be that through captive agents, be that through agents who are on staff of insurance companies. So we regulate the distribution system through a licensing process. And, of course, the companies themselves have to go through a licensing process.

The way it's worked in the past, particularly as you look at them, let me start with the solvency issue.

By and large, the process takes place by way of financial exams, but also through rate regulation and form regulation and certain lines of business. And it varies sometimes from state to state, al-

beit—but certain lines of business have to go through rate reapprovals, certain lines of business go through product reapprovals, on the property and casualty side.

To differentiate that from the life side, on the life side there has never been rate regulation at the state level. There has always been—the regulatory process has always been confined to product regulation, to form regulation, if you will.

So there is some differentiation there between the approaches, but, by and large, the system, when you look at it historically, when you look at it from the standpoint of solvency regulation, for instance, of—yes, there have been hiccups here and there—we had some hiccups back in the 1980s, when Chairman Dingle, you might recall, had a lot to say about what was happening in the industry—but, by and large, the state system has worked.

And now, of course, we're faced with the fact that there are a number of drivers in the market that, in essence, dictate that regulators go back and take a new look at how we regulate. And when I say "the drivers," I mean, things like convergence, for instance. Certainly, what Gramm-Leach-Bliley, the legislation that was passed several years ago, has made clear is that there is, in fact, a convergence of products in the financial sector—banking, securities, insurance—and that in many ways what we're speaking of is really one financial sector, no longer this artificial division between banking, securities, and insurance. With that convergence, of course, new competitors, in fact, the insurance industry finds itself with new competitors, with a need for new products, with a new need for innovation, with a new need for pricing flexibilities, for instance, so this is one of the drivers. Technology is another one, communications and information technology, for instance. And then, of course, we hear the overused word of globalization, but it is a reality, because if there ever was a global industry, it's the reinsurance industry. Most of our reinsurers, with one or two exceptions, are now entirely offshore. All the large ones are offshore—German companies, French companies, Bermuda companies, and so on. So there is a globalization factor that needs to be considered.

And as a result of that, at the NAIC level, and also at the state level, we've, for instance, in South Carolina, undertaken many a reform, in essence, to provide a more market-driven kind of system. And to answer Senator Lautenberg, in that respect, South Carolina, for instance, we've gone through a file-and-use system with rate bans, and under that system, we have managed, in essence, to attract over 200 new companies into the state, and we have done away with what used to be a state reinsurance facility that had 43 percent of the market and incurred between $180 million and $200 million a year in deficits, by and large because rate suppression was taking place within that mechanism of the state reinsurance facility.

So both at the state level, as well as at the NAIC level, we've undertaken a reform effort. In the aftermath, particularly in the aftermath, as I said, of Gramm-Leach-Bliley. At the NAIC, these reforms have included an entire review, which is in—work in progress, of our market conduct function to make it more coordinated. We understand that's a considerable cost to the industry, and we do want to make the process more efficient. It is disjointed

at this point. It needs more coordination. Speed-to-market initiatives, licensing under the NARAB provisions, for instance, of Gramm-Leach-Bliley, we've made much more efficient, so that there's reciprocity. Streamlining mergers and acquisitions. And, of course, throughout this process we work very closely with NCOIL, the Conference of Insurance Legislators, as well as with NCSL, the state legislature.

Our fear of a Federal, some type of Federal intervention in the process very simply is that we end up with two systems, and that may well be good for companies, insofar as choice is concerned, but we think it's bad for consumers. We really think that consumers that face a choice of two different levels of consumer protections, that isn't the ideal world for consumers. So we're very much in favor of maintaining and reforming the state-based system, fully realizing that change in many ways, indeed, is necessary.

Second, we don't think that the Federal Government really has done all that great a job——

The CHAIRMAN. Mr. Csiszar, you're going to have to abbreviate, please.

Ms. CSISZAR. I will make it short, thank you—that the Federal Government has done all that great a job in other respects, and we really think that state regulation has proven itself over the years. And I'll leave it at that to questions, Mr. Chairman.

[The prepared statement of Mr. Csiszar follows:]

PREPARED STATEMENT OF ERNST CSISZAR, VICE PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Introduction

Good morning, my name is Ernst Csiszar. I am the Director of Insurance for the State of South Carolina, and this year I am serving as Vice President of the National Association of Insurance Commissioners (NAIC). I am pleased to be here on behalf of the NAIC and its members to provide the Committee on Commerce, Science and Transportation with an overview and update of our efforts to modernize state insurance supervision to meet the true demands of the 21st Century.

Today, I would like to make three basic points—

- First, effective consumer protection that focuses on local needs is the hallmark of state insurance regulation because we understand local and regional markets and the needs of consumers in those markets.
- Second, with the NAIC's adoption in September 2003 of "*A Reinforced Commitment: Insurance Regulatory Action Plan*", state regulators are on time and on target to accomplish changes needed to modernize the system of insurance regulation in the United States. Our goal is to achieve a more uniform state regulatory system because it makes sense for both consumers and insurers. However, in areas where different standards among states are required because they address regional needs, we are harmonizing state regulatory procedures to ease compliance by insurers and agents doing business in those markets.
- Third, we believe any Federal legislation dealing with insurance regulation carries the risk of creating an unnecessary bureaucracy and the risk of undermining state consumer protections due to unintended or unnecessary preemption of state laws and regulations.

Why Are Insurance Companies and Agents Regulated?

As the Senate Commerce Committee evaluates state insurance regulation, members of the NAIC hope you will start by asking the fundamental question: "Why are insurance companies and agents regulated in the United States?" Government regulation of insurance companies and agents began in the states well over a century ago for one overriding reason—to protect consumers. Our most important consumer protection is to assure that insurers remain solvent so they can meet their obligations to pay claims, as recently evidenced in the aftermath of September 11th and Hurricane Isabel. Beyond that, states supervise insurance sales and marketing prac-

tices, as well as policy terms and conditions, to ensure that consumers are treated fairly when they purchase insurance products and file claims.

It is fair to ask how the system of regulation can be made most compatible with the demands of commercial competition without sacrificing the needs of consumers. As the Director of the South Carolina Department of Insurance, I believe that competition, within the proper regulatory framework, can be used as an effective component of insurance regulation. Consumers benefit directly from competitive insurance markets.

Protecting Consumers is the First Priority of State Insurance Regulation

Protecting insurance consumers in a world of hybrid institutions and products must start with a basic understanding that insurance is a different business than banking and securities. Insurance is a commercial product based upon subjective business decisions. As regulators of insurance, state governments are responsible for making sure the expectations of American consumers are met regarding financial safety and fair treatment by insurance providers. The states maintain a system of financial guaranty funds that cover personal losses of consumers in the event of an insurer insolvency. The entire state insurance system is authorized, funded, and operated at no cost to the Federal government.

States Have a Strong Record of Successful Consumer Protection

There have been charges from some industry groups that the state regulatory system is inefficient and burdensome, and that a single Federal regulator would be better. As government officials responsible for operating the state system, we understand that *any* government regulation, including insurance regulation, may be considered inconvenient and occasionally frustrating to those persons who wish to do business on their own terms.

However, the NAIC and its members do not believe the consumers we serve each day think we are inefficient or burdensome. During 2001, we handled approximately 3.6 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents. Many of those calls led to a successful resolution of the problem at little or no cost to the consumer. This does not include the numerous industry complaints that were successfully resolved by regulators.

The September 11, 2001 terrorist attacks on America were a horrible and tragic event that exposed serious weaknesses in certain government operations in this country. Yet the state insurance regulatory system was proven to be sound, even when hit with a sudden $40 billion catastrophe that ultimately will be the most expensive in history. If our existing system operates smoothly under the most horrific and unexpected conditions, we question why anyone would want to supplant it.

State regulators know from years of firsthand experience that when consumers need help with insurance sales or claims problems, they naturally look to their state agency to get assistance. We are accessible through a local call or visit, and every state has trained staff and programs to assist consumers promptly.

State Regulatory Modernization: On Time and On Target

While recognizing the inherent strength of the state system when it comes to protecting consumers, we also agree that there is a need to improve the efficiency of the system. In March 2000, the Nation's insurance commissioners committed to modernizing the state system by endorsing an action plan entitled "*Statement of Intent—The Future of Insurance Regulation.*" Working in their individual states and collectively through the NAIC, we have made tremendous progress in achieving an efficient, market-oriented regulatory system for the business of insurance as shown below—

Producer Licensing and Reciprocity

- Adopted the Producer Licensing Model Act (PLMA) that 49 states have enacted.
- By year-end 2002, 36 states had implemented State Licensing Reciprocity, thus exceeding the Federal mandate. To date, 39 states now implement SLR.
- Via the NAIC's affiliate, the National Insurance Producer Registry (NIPR), we've created the Producer Database, which holds information relating to over 3 million insurance agents and brokers. 50 states, D.C. and Puerto Rico now use the Producer Database to share information; 1,200 insurers also utilize it.
- 15 states now use the NIPR Gateway, a system that links state regulators electronically with insurance companies to facilitate the exchange of producer information. Allows for the exchange of non-resident license applications, appointment renewals and termination information.

- Have created a streamlined company licensing system via uniform laws and electronic processing, called the Uniform Certificate of Authority Application (UCAA). 51 jurisdictions now accept the UCAA licensing application.

Speed to Market

- Created the System for Electronic Rate and Form Filing (SERFF) in 2001.
- As of August 31, 2003, more than 48,000 filings were submitted via SERFF to the states, an 88 percent increase over all filings in 2002. The target for 2003 is 75,000 filings.
- Total number of insurance companies licensed to use SERFF now exceeds 885, including major players such as Prudential, Liberty Mutual, Manulife, The Hartford and Zurich America.
- To date, 50 states accept property/casualty filings via SERFF, 48 states accept life insurance filings via SERFF, and 41 states accept health insurance filings via SERFF.
- Goal of all states accepting rate and form filings via SERFF, for all lines of insurance and all filing types, by December 31, 2003.
- Average turnaround time for filings made via SERFF is only 17 days.

Market Conduct and Consumer Protection

- Drafted the Uniform Examination Outline
- 42 states currently certify compliance with two or more of the following exam areas: scheduling, pre-exam planning, procedures, and reports.
- Created the Consumer Information Source (CIS) link on the NAIC website, allowing consumers to file complaints electronically, research complaint history of insurance companies and to search and download information on selected insurance companies.

We have now taken the next step of developing specific program targets and establishing a common schedule for implementing them. At the NAIC's Fall National Meeting in September 2003, we adopted *"A Reinforced Commitment: Insurance Regulatory Action Plan"* (See Attachment A). This landmark document—the result of lengthy discussions and difficult negotiations—puts the states on a track to reach all key modernization goals at scheduled dates ranging from December 31, 2003 to December 31, 2008.

Let me point out that these specific regulatory program targets were developed with extensive input from industry and consumer representatives who are active in the NAIC's open committee process. To our knowledge, *every* legitimate complaint regarding inefficiency and redundancy in the state system has been effectively addressed by our new regulatory action plan that will phase-in the necessary improvements over the next five years. Even if an alternative Federal regulatory system were set up tomorrow, there is no way it could achieve these improvements on a schedule that comes close to the aggressive timetable which state regulators have adopted voluntarily.

Specific Action Goals in the NAIC Plan

Although a complete description of our detailed program is contained in Attachment A, the following is a summary of NAIC's declared principles and goals reflecting our commitment to continue modernizing insurance regulation:

I. Consumer Protection

"An open process . . . access to information and consumers' views . . . our primary goal is to protect insurance consumers, which we must do proactively and aggressively, and provide improved access to a competitive and responsive insurance market."

II. Market Regulation

"Market analysis to assess the quality of every insurer's conduct in the marketplace, uniformity, and interstate collaboration . . . the goal of the market regulatory enhancements is to create a common set of standards for a uniform market regulatory oversight program that will include all states."

III. Speed-to-Market for Insurance Products

"Interstate collaboration and filing operational efficiency reforms . . . state insurance commissioners will continue to improve the timeliness and quality of the reviews given to insurers' filings of insurance products and their corresponding advertising and rating systems."

IV. Producer Licensing

> *"Uniformity of forms and process . . . the NAIC's broad, long-term goal is the implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance."*

V. Insurance Company Licensing

> *"Standardized filing and baseline review procedures . . . the NAIC will continue to work to make the insurance company licensing process for expanding licensure as uniform as appropriate to support a competitive insurance market."*

VI. Solvency Regulation

> *"Deference to lead states . . . state insurance regulators have recognized a need to more fully coordinate their regulatory efforts to share information proactively, maximize technological tools, and realize efficiencies in the conduct of solvency monitoring."*

VII. Change In Insurance Company Control

> *"Streamline the process for approval of mergers and other changes of control."*

NAIC members understand that these goals present difficult challenges; however, with the active participation of governors and state legislators, as well as industry and consumer advocates, we are confident that NAIC member states will achieve these goals in the near term.

Achieving State Uniformity for Life Insurance Products

Life insurance product approval by regulators is an area that deserves special comment. Where appropriate, the NAIC and the states are working to achieve full regulatory uniformity to benefit both consumers and insurance providers. Marketing life insurance is an area where we agree with industry that uniformity is needed to enable life insurers to market products nationally. In fact, aside from producer licensing, this is one of the few areas that has generated a true national consensus for reform among all segments of industry, consumers, and regulators.

To accomplish uniform supervision of life insurance products within the state system, the NAIC—in consultation with state legislators—developed an interstate compact model that we are working to get adopted by the states. The goal of the compact is to establish a single point of filing where life insurers would file their products for approval and thereafter, assuming the product satisfies appropriate product standards created jointly by the compacting states, be able to sell those products in multiple states without the need for making separate filings in each state.

The key points that make a compact attractive are: (1) the states will continue to regulate product approvals for annuities and life insurance products through the compact (as opposed to Federal preemption); (2) each state in the compact helps govern the activities of the compact; (3) we do not anticipate that states will lose revenues generated through product filings; and (4) states will be able to withdraw from the compact through legislative action.

Market Regulation—More Difficult to Harmonize than Financial Regulation

Another regulatory area that deserves special comment is market regulation. The GAO issued a report on this subject in September 2003 entitled "Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation" (GAO–03–433). While the NAIC cooperated with GAO and agrees with much of the GAO's analysis, we believe a deeper understanding of how market regulation works is necessary to appreciate the difficulties any regulatory agency faces in attempting to harmonize market conduct processes.

On the financial regulation side, the NAIC and the states have developed an effective accreditation system that is built on the concept of domiciliary deference (*i.e.,* the state where the insurer is domiciled takes the lead role). This makes eminent sense because financial records do not change state to state; if one state has reviewed financial records and determined a company to be in good standing, it would truly be redundant for another state to review those same records. The market side is not as straightforward. The market behaviors of insurers can be quite different from one state to another, both because the laws may be different and because insurer compliance with the laws may vary by state. In short, market regulation is definitely *not* an area where "one size fits all" across the country.

Efforts to improve market regulation must start by recognizing that it is multi-faceted, and that the best way to make market regulation both more effective and more efficient is to focus on bringing more coordination to the various facets of regulation. The NAIC has identified seven major market regulatory components that are common to all state insurance departments:

- Consumer complaint handling
- Producer licensing
- Rate and form review
- Market analysis
- Market conduct examinations
- Investigations
- Enforcement

In addition, state insurance departments typically include various other ancillary activities, such as consumer education and outreach, oversight of residual markets, and antifraud programs.

A *formal* market analysis program is being integrated into the market surveillance programs as a part of our modernization efforts. Effective use of market analysis techniques, such as enhanced data sharing and interpretation, can also help achieve coordinated state regulatory action with substantially less redundancy and cost. While market conduct examinations may require more collaboration and consistency, they will continue to be necessary components of market surveillance.

The NAIC has been looking carefully at the extent to which one state can rely on the findings of another state when it comes to making regulatory decisions about examinations, investigations, and enforcement actions. We are looking at collaborative models for relying on the domestic state (or some combination of states) for baseline monitoring of companies, and we have several specific collaborative projects underway. But, ultimately, we cannot escape the fact that regulatory violations can affect consumers in different states quite differently. Because regulators are government officials who must enforce the laws of their state, they cannot delegate that responsibility to someone who may not understand or appreciate the nature of a particular violation and its impact on local consumers. Any modernized market surveillance program developed must contain sufficient flexibility to permit states to enforce their laws and protect their citizens.

We believe much progress can be made to achieve the goals of efficiency sought by industry representatives in our market surveillance processes. However, we do not overlook the fact that insurance must be regulated to protect local consumers. Regulatory efficiency for its own sake should not undermine the credibility and effectiveness of the state regulators charged with enforcing consumer protection laws.

Federal Legislation Must Not Undermine State Modernization Efforts

The NAIC and its members believe Congress must be very careful in considering potential Federal legislation to achieve modernization of insurance regulation in the United States. Even well-intended and seemingly benign Federal legislation can have a substantial adverse impact on state laws and regulations that protect insurance consumers. For example, when Congress passed the Gramm-Leach-Bliley Act (GLBA) in 1999, it acknowledged once again that states should regulate the business of insurance in the United States, as set forth originally in the McCarran-Ferguson Act. There was a careful statutory balancing of regulatory responsibilities among Federal banking and securities agencies and state insurance departments, with the result that Federal agencies would not be involved in making regulatory determinations about insurance matters. Even though Congress tried very hard in GLBA to craft language that would *not* preempt state laws unnecessarily, there have already been disagreements and inconsistent interpretations about the extent to which federally-chartered banks may conduct insurance-related activities without complying with state laws.

We fully expect that creating a Federal charter for insurers, along with its Federal regulatory structure, will cause far greater problems for states and insurance regulation in general than those resulting from the GLBA provisions dealing with banks. For instance, federally-chartered insurers would certainly insist that state laws involving solvency and market conduct cannot “prevent or significantly interfere” with their federally-granted powers to conduct insurance business anywhere in the United States. The result will be years of market and regulatory confusion that will benefit the legal community rather than insurance providers and consumers.

The Impact of Federal Chartering on State Regulation Will Not Be Optional

A Federal charter and its regulatory system would result in two separate insurance systems operating in each state. The first would be the current system of supervision by state insurance departments under state law that will continue responding directly to state voters and taxpayers.

The second system would be a new Federal regulator with zero experience in the local state laws that control the content of insurance policies, claims procedures, contracts, and legal rights of citizens in tort litigation. This new Federal regulator would undoubtedly have the power to preempt state laws that disagree with the laws governing policyholders and claimants of federally-chartered insurers. At the very least, this situation will lead to confusion. At worst, it will lead to two levels of consumer protection based upon whether an insurer is chartered by Federal or state government.

Granting a government charter for an insurer means taking full responsibility for the consequences, including the costs of insolvencies and the complaints of consumers. The states have fully accepted these responsibilities by covering all facets of insurance licensing, solvency monitoring, market conduct, and handling of insolvent insurers. The NAIC does not believe Congress will have the luxury of granting insurer business licenses without also being drawn into the full range of responsibilities that go hand-in-hand with a government charter to underwrite and sell insurance.

Despite our different sizes, geography, and market needs, states work together through the NAIC as legal equals under the present system. We find solutions as a peer group through give-and-take and mutual respect, knowing that no single state can force its own way over the objections of other states. Keeping in mind that the original purpose of regulation is to protect consumers, we believe such participatory democracy and state decision-making based upon the realities of local markets is a major strength of our system for regulating insurers and agents.

A Federal insurance regulator would not be just another member of NAIC, it would instead be a super-agency with power to intervene and overrule every state and territory under United States jurisdiction. The local needs and wants of citizens protected under state laws would be subjugated to the national agenda of insurers and Federal regulators.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand that commercial insurance markets have changed, and that modernization of state insurance standards and procedures is needed to ease regulatory compliance for insurers and agents.

We ask Congress and insurance industry participants to work with us to implement the specific improvements set forth in NAIC's *A Reinforced Commitment: Insurance Regulatory Modernization Action Plan* through the state legislative system. That is the only practical way to achieve necessary changes quickly in a manner that preserves state consumer protections expected by the public. The NAIC and its members will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation while preserving its long-standing dedication to protecting American consumers.

ATTACHMENT A

President Commissioner Mike Pickens (Arkansas)

Vice President Director Ernst Csiszar (South Carolina)

Secretary-Treasurer Administrator Joel Ario (Oregon)

Immediate Past President Commissioner Terri Vaughan (Iowa)

A REINFORCED COMMITMENT:
INSURANCE REGULATORY MODERNIZATION ACTION PLAN

In March 2000, the National Association of Insurance Commissioners put forth our *Statement of Intent—The Future of Insurance Regulation.* Working in our individual states and collectively through the NAIC, we have made tremendous progress. We are proud of what has been accomplished, but believe more dramatic advances in unifying state regulatory processes are needed to further improve insurance marketplace efficiencies and to protect the needs of insurance consumers in the 21st Century.

The National Association of Insurance Commissioners is renewing our commitment to modernizing the state-based system of insurance regulation. As committed in our original *Statement of Intent,* our primary goal is to protect insurance consumers, which we must do proactively and aggressively. We also recognize that consumers and the marketplace are best served by efficient, market-oriented regulation of the business of insurance.

The insurance industry must operate on a financially sound basis in order to manage risk and to provide financial protection to families and businesses. Our Nation's economy depends on the insurance industry's ability to effectively manage risk. A solid regulatory framework provides for efficient, safe, fair and stable insurance markets.

Like other sectors of the financial services marketplace, the insurance industry and its products are changing in response to the wants and needs of consumers. Increasingly the insurance industry is viewed in a global context. Advances in technology facilitate the opportunity to offer new insurance products thus providing consumers with greater choice and enabling them to become better informed as to those choices.

States have met the challenge of regulating a national and international business on a fifty state basis using a number of innovative mechanisms. The NAIC Financial Regulation and Accreditation Standards Program has served the insurance industry and consumers well for the past fourteen years. The program has ensured coherent financial solvency oversight and has proven to be a highly effective approach within the state-based system. As licensing states substantially defer to the insurer's home state for nearly all aspects of financial and solvency regulation, the state solvency system promotes intelligent and efficient use of finite regulatory resources. By focusing on those insurers that pose solvency risks, this system has strengthened protection of policyholders and benefited both the insurance industry and policyholders by minimizing regulatory costs. While NAIC members continue to seek greater effectiveness and improvements to the financial standards of the program, it can serve as a template for market based regulatory reforms.

Using this state-based solvency system as a model, the members of the NAIC will design and implement similar uniform standards for producer licensing, market conduct oversight, and rate and form regulation. In addition, the NAIC will expand the existing financial regulation framework to institute true uniformity and reciprocity in company licensing requirements, and further enhance financial condition examinations, and changes of an insurer's control during mergers and acquisitions.

PRINCIPLES AND GOALS

The following is a declaration of NAIC principles and goals reflecting our commitment to continuing to modernize insurance regulation:

I. Consumer Protection

"An open process . . . access to information and consumers' views . . . our primary goal is to protect insurance consumers, which we must do proactively and aggressively, and provide improved access to a competitive and responsive insurance market."

II. Market Regulation

"Market analysis to assess the quality of every insurer's conduct in the marketplace, uniformity, and interstate collaboration . . . the goal of the market regulatory enhancements is to create a common set of standards for a uniform market regulatory oversight program that will include all states."

III. Speed-to-Market for Insurance Products

"Interstate collaboration and filing operational efficiency reforms . . . state insurance commissioners will continue to improve the timeliness and quality of the reviews given to insurers' filings of insurance products and their corresponding advertising and rating systems."

IV. Producer Licensing

"Uniformity of forms and process . . . the NAIC's broad, long-term goal is the implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance."

V. Insurance Company Licensing

"*Standardized filing and baseline review procedures . . . the NAIC will continue to work to make the insurance company licensing process for expand-*

ing licensure as uniform as appropriate to support a competitive insurance market."

VI. Solvency Regulation

"Deference to lead states . . . state insurance regulators have recognized a need to more fully coordinate their regulatory efforts to share information proactively, maximize technological tools, and realize efficiencies in the conduct of solvency monitoring."

VII. Change In Insurance Company Control

"Streamline the process for approval of mergers and other changes of control."

NAIC members understand that these goals present difficult challenges; however, with the active participation of state governors and state legislators, industry and consumer advocates, and state insurance department regulators, we are confident NAIC member states will achieve these goals in the near term.

* * *

ACTION PLAN

I. Consumer Protection

An open process . . . access to information and consumers' views . . . our primary goal is to protect insurance consumers, which we must do proactively and aggressively, and provide improved access to a competitive and responsive insurance market.

The NAIC members will keep consumer protection as their highest priority by:

(1) Providing NAIC access to consumer representatives and having an active organized strategy for obtaining the highly valued input of consumer representatives in the proceedings of all NAIC committees, task forces, and working groups;

(2) Developing disclosure and consumer education materials, including written and visual consumer alerts, to help ensure consumers are adequately informed about the insurance market place, are able to distinguish between authorized an unauthorized insurance products marketed to them, and are knowledgeable about state laws governing those products;

(3) Providing an enhanced Consumer Information Source (CIS) as a vehicle to ensure consumers are provided access to the critical information they need to make informed insurance decisions;

(4) Reviewing and assessing the adequacy of consumer remedies, including state arbitration laws and regulations, so that the appropriate forums are available for adjudication of disputes regarding interpretation of insurance policies or denials of claims; and

(5) Developing and reviewing consumer protection model laws and regulations to address consumer protection concerns.

II. Market Regulation

Market analysis to assess the quality of every insurer's conduct in the marketplace, uniformity, and interstate collaboration . . . the goal of the market regulatory enhancements is to create a common set of standards for a uniform market regulatory oversight program that will include all states.

The NAIC has established market analysis, market conduct, and interstate collaboration as the three pillars on which the states' enhanced market regulatory system will rest. The NAIC recognizes that the marketplace is generally the best regulator of insurance-related activity. However, there are instances where the market place does not properly respond to actions that are contrary to the best interests of its participants. A strong and reasonable market regulation program will discover these situations, thereby allowing regulators to respond and act appropriately to change company behavior.

Market Analysis

While all states conduct market analysis in some form, it is imperative that each state have a formal and rigorous market analysis program that provides consistent and routine reports on general market problems and companies that may be operating outside general industry norms. To meet this goal:

(1) Each state will produce a standardized market regulatory profile for each "nationally significant" domestic company. The creation of these profiles will depend upon the collection of data by each state and each state's full participation in the NAIC's market information systems and new NAIC market analysis standards; and

(2) Each state will adopt uniform market analysis standards and procedures and integrate market analysis with other key market regulatory functions.

Market Conduct

States will also implement uniform market conduct examination procedures that leverage the use of automated examination techniques and uniform data calls; and

(1) States will implement uniform training and certification standards for all market regulatory personnel, especially market analysts and market conduct examiners; and

(2) The NAIC's Market Analysis Working Group will provide the expertise and guidance to ensure the viability of uniform market regulatory oversight while preserving local control over matters that directly affect consumers within each state.

Interstate Collaboration

The implementation of uniform standards and enhanced training and qualifications for market regulatory staff will create a regulatory system in which states have the confidence to rely on each other's regulatory efforts. This reliance will create a market regulatory system of greater domestic deference, thus allowing individual states to concentrate their market regulatory efforts on issues that are unique to their individual market place conditions.

(1) Each state will monitor its "nationally significant" domestic companies on an on-going basis, including market analysis and appropriate follow up to address any identified problems;

(2) Market conduct examinations of "nationally significant" companies performed by a non-domestic state will be eliminated unless there is a specific reason that requires a targeted market conduct examination; and

(3) The Market Analysis Working Group will assist states to identify market activities that have a national impact and provide guidance to ensure that appropriate regulatory action is being taken against insurance companies and producers and that general market issues are being adequately addressed. This peer review process will become a fundamental and essential part of the NAIC's market regulatory system.

III. "Speed-to-Market" for Insurance Products

Interstate collaboration and filing operational efficiency reforms. . .state insurance commissioners will continue to improve the timeliness and quality of the reviews given to insurers' filings of insurance products and their corresponding advertising and rating systems.

Insurance regulators have embarked on an ambitious 'Speed-to-Market Initiative' which covers the following four main areas:

(1) Integration of multi-state regulatory procedures with individual state regulatory requirements;

(2) Encouraging states to adopt regulatory environments that place greater reliance on competition for commercial lines insurance products;

(3) Full availability of a proactively evolving System for Electronic Rate and Form Filing (known as 'SERFF') that includes integration with operational efficiencies (best practices) developed for the achievement of speed-to-market goals; and

(4) Development and implementation of an interstate compact to develop uniform national product standards and provide a central point of filing.

Integration of Multi-state Regulatory Procedures

It is the goal that all state insurance departments will be using the following regulatory tools by December 31, 2008:

(1) Review standards checklists for insurance companies to verify the filing requirements of a state before making a rate or policy form filing;

(2) Product requirements locator tool, which is already in use, will be available to assist insurers to locate the necessary requirements of the various states

to use when developing their insurance products or programs for one or multiple-state markets;

(3) Uniform product coding matrices, already developed, will allow uniform product coding so that insurers across the country can code their policy filings using a set of universal codes without regard for where the filing is made; and

(4) Uniform transmittal documents to facilitate the submission of insurance products for regulatory review. The uniform transmittal document contains information that is necessary to track the filing through the review process and other necessary information. The goal is that all states adopt it for use on all filings and databases related to filings by December 31, 2003.

Adoption of Regulatory Frameworks that Place Greater Reliance on Competition

States will continue to ensure that the rates charged for products are actuarially sound and are not excessive, inadequate or unfairly discriminatory. To the extent feasible, for most markets, states recognize that competition can be an effective element of regulation. While recognizing that state regulation is best for insurance consumers, it also recognizes that state regulation must evolve as insurance markets change.

Full availability of a proactively evolving System for Electronic Rate and Form Filing (SERFF)

SERFF is a one-stop, single point of electronic filing system for insurance products. It is the goal of state insurance departments to be able to receive product filings through SERFF for all major lines and product types by December 2003. We will integrate all operational efficiencies and tools with the SERFF application in a manner consistent with our Speed-to-Market Initiatives and the recommendations of the NAIC's automation committee.

Implementation of an Interstate Compact

Many products sold by life insurers have evolved to become investment-like products. Consequently, insurers increasingly face direct competition from products offered by depository institutions and securities firms. Because these competitors are able to sell their products nationally, often without any prior regulatory review, they are able to bring new products to market more quickly and without the expense of meeting different state requirements. Since policyholders may hold life insurance policies for many years, the increasing mobility in society means that states have many consumers who have purchased policies in other states. This reality raises questions about the logic of having different regulatory standards among the states.

The Interstate Insurance Product Regulation Compact will establish a mechanism for developing uniform national product standards for life insurance, annuities, disability income insurance, and long-term care insurance products. It will also create a single point to file products for regulatory review and approval. In the event of approval, an insurer would then be able to sell its products in multiple states without separate filings in each state. This will help form the basis for greater regulatory efficiencies while allowing state insurance regulators to continue providing a high degree of consumer protection for the insurance buying public.

State insurance regulators will work with state law and policymakers with the intent of having the Compact operational in at least 30 states or states representing 60 percent of the premium volume for life insurance, annuities, disability income insurance and long-term care insurance products entered into the Compact by year-end 2008.

IV. Producer Licensing Requirements

Uniformity of forms and process . . . the NAIC's broad, long-term goal is the implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance.

The states have satisfied GLBA's licensing reciprocity mandates and continue to view licensing reciprocity as an interim step. Our goal is uniformity.

Building upon the regulatory framework established by the NAIC in December of 2002, the NAIC's members will continue the implementation of a uniform, electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance. While preserving necessary consumer protections, the members of the NAIC will achieve this goal by focusing on the following five initiatives:

(1) Development of a single uniform application;

(2) Implementation of a process whereby applicants and producers are required to satisfy only their home state pre-licensing education and continuing education (CE) requirements;

(3) Consolidation of all limited lines licenses into either the core limited lines or the major lines;
(4) Full implementation of an electronic filing/appointment system; and
(5) Implementation of an electronic fingerprint system. In accomplishing these goals, the NAIC recognizes the important and timely role that state and Federal legislatures must play in enacting necessary legislation.

National Insurance Producer Registry (NIPR)

Through the efforts of NIPR, major steps have been taken to streamline the process of licensing non-residents and appointing producers, including the implementation of programs that allow electronic appointments and terminations. Other NIPR developments helping to facilitate the producer licensing and appointment process include:

(1) Use of a National Producer Number, which is designed to eliminate sole dependence on using social security numbers as a unique identifier;
(2) Acceptance of electronic appointments and terminations or registrations from insurers; and
(3) Use of Electronic Funds Transfer for payment of fees. The goal is to have full state implementation of the services provided by NIPR by December of 2006.

V. Insurance Company Licensing

Standardized filing and baseline review procedures. . .the NAIC will continue to work to make the insurance company licensing process for expanding licensure as uniform as appropriate to support a competitive insurance market.

Except under certain limited circumstances, insurance companies must obtain a license from each state in which they plan to conduct business. In considering licensure, state regulators typically assess the fitness and competency of owners, boards of directors, and executive management, in addition to the business plan, capitalization, lines of business, market conduct, etc. The filing requirements for licensure vary from state to state, and companies wishing to be licensed in a number of states have to determine and comply with each state's requirements. In the past three years, the NAIC has developed, and all states have agreed to participate in, a Uniform Certificate of Authority Application process that provides significant standardization to the filing requirements that non-domestic states use in considering the licensure of an insurance company.

In its commitment to upgrade and improve the state-based system of insurance regulation in the area of company licensing, the NAIC will:

(1) Maximize the use of technology and pre-population of data needed for the review of application filings;
(2) Develop a Company Licensing Model Act to establish standardized filing requirements for a license application and to establish uniform licensing standards; and
(3) Develop baseline licensing review procedures that ensure a fair and consistent approach to admitting insurers to the marketplace and that provide for appropriate reliance on the work performed by the domestic state in licensing and subsequently monitoring an insurer's business activity.

As company licensing is adjunct to a solvency assessment, the members of the NAIC will consider expanding the Financial Regulation and Accreditation Standards Program to incorporate the licensing and review requirements as appropriate. This action will assure appropriate uniformity in company licensing and facilitate reciprocity among the states. As much of this work is well underway, the NAIC will implement the technology and uniform review initiatives, and draft the model act by December 2004.

VI. Solvency Regulation

Deference to lead states. . .state insurance regulators have recognized a need to more fully coordinate their regulatory efforts to share information proactively, maximize technological tools, and realize efficiencies in the conduct of solvency monitoring.

Deference to "Lead States"

Relying on the concept of "lead state" and recognizing insurance companies by group, when appropriate, the NAIC will implement procedures for the relevant domestic states of affiliated insurers to plan, conduct and report on each insurer's financial condition.

Financial Examinations

In regard to financial examinations, many insurers are members of a group or holding company system that has multiple insurers and that may have multiple states of domicile. These affiliated insurers often share common management along with claims, policy and accounting systems, and participate in the same reinsurance arrangements. Requirements for coordination of financial examinations will be set forth in the NAIC *Financial Condition Examiners Handbook.* To allow time for the states to adjust examination schedules and resources, such coordination will be phased in over the next 5 years, with the goal of full adherence to the Handbook's guidance for examinations conducted as of December 2008.

Insolvency Model Act

The NAIC will promote uniformity by reviewing the Insolvency Model Act, maximizing use of technology, and developing procedures for state coordination of imminent insolvencies and guaranty fund coverage. The Financial Regulation Standards and Accreditation Committee will consider the requirements no later than January 1, 2008.

VII. Changes of Insurance Company's Control

Streamline the process for approval of mergers and other changes of control.

Coordination Using "Lead States"

Regulatory consideration of the acquisition of control or merger of a domestic insurer is an important process for guarding the solvency of insurers and protecting current and future policyholders. At the same time, NAIC members realize that these transactions are time sensitive and the process can be daunting when approvals must be obtained in multiple states. As a result, states will enhance their coordination and communication on acquisitions or mergers of insurers domiciled in multiple states by designing a system through which these multi-state reviews are coordinated by one or more "lead" states.

Form A Database

Insurers are required to file for approval on documents referred to as Form A filings when mergers or acquisitions are being considered. The NAIC has created a database to track these filings so that this information is available to all state regulators. Usage will be monitored to ensure that all states use the application to improve coordination of Form A reviews and to alert state regulators to problem filings. The Form A Review Guide and Form A Review Checklist, which contain procedures to be utilized when reviewing a Form A Filing, will be enhanced and incorporated into the existing NAIC *Financial Analysis Handbook* as a supplement. NAIC members will work on amending the Accreditation Program to include the Form A requirements to further promote stronger solvency standards and state coordination, as well as an efficient process for our insurers. The Form A requirements will be targeted for incorporation into the Accreditation Program no later than January 1, 2007.

Integrate Policy Form Approval and Producer Licensing into the Merger and Acquisition Process

The NAIC members will develop procedures for the seamless transfer of policy form approvals and producer appointments to take place contemporaneously with the approval of mergers or acquisitions where appropriate. We will begin developing and testing these procedures through pilot programs in 2003 and fully incorporate them system wide by 2006.

* * *

The CHAIRMAN. Thank you very much.

I think we'll move to Mr. Hunter.

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Thank you, Mr. Chairman. Is this on?

The CHAIRMAN. Yes, sir.

Mr. HUNTER. Insurance regulation is at a crossroads, so this is a very appropriate hearing, and it's good to see former insurance commissioner, who stepped down to become a Senator, Bill Nelson, up there with you all.

[Laughter.]

Mr. HUNTER. Elements of the insurance industry want to be regulated by the Federal Government, or at least have the option, and other strong elements of the industry don't want Federal regulation at all. But while they disagree on whether there should be a Federal role, they do not disagree about using the threat of a Federal role to leverage the states to press them to hold off or reduce consumer protections, using threats like this. A Liberty Mutual executive told the NAIC that they were losing insurance companies every day to political support for the Federal option, and that their huge effort to deregulate and speed product approval was too little and too late. He called for an immediate step up of deregulation and measurable victories to stem the tide toward a Federal role. I could give you hundreds of examples of that kind of language from insurance executives.

They have a powerful ally in Chairman Oxley, who's held a series of ten hearings at least in which he constantly pressurizes the states with statements such as, "Congress is going to come up with their own solution if they don't move. State legislators and insurance commissioners must enact deregulation reform."

Even some insurance commissioners have piled on. Just last week, Mr. Csiszar spoke to industry executives saying, "You have to force us at the NAIC, hold a club over our heads, knock us over the head, use every tool in your bag."

But, meanwhile, the NAIC is failing, and the states, in many ways. The NAIC has failed to do anything about unsuitable sales of insurance in any line of insurance. They've failed to do anything as an organization on the use of credit scoring, an issue that is just rife, and people are just very upset. They haven't fixed the market-conduct mess the GAO has recently commented upon.

Meanwhile, they're rolling back consumer protections. They've passed a deregulation for small businesses at the NAIC, and states have adopted that, many states, and other states have been rolling back even personal auto insurance and homeowner protections for consumers.

There are good reasons that insurance is subject to regulation. We've heard some already. The most obvious one, the consumer pays today, gets the product, maybe, years later. There's a solvency threat, there's dishonesty, there are lots of reasons why you have to regulate.

Product regulation is very important for consumers. An insurance contract is a very complex legal document, and consumers cannot be expected to pick out good and bad ones. They need someone to check and make sure that they meet state laws and are reasonable.

Price regulation is a very complex issue. Insurance is not a product like a can of peas. Once a consumer is sure that policies being compared are the same, which is a problem of a serious magnitude, the level of service offered by insurers must be determined, then there's the solvency of the insurance company, finally there's the

price. Some insurers have many tiers. I just heard yesterday that there's one insurance company that's filed in Florida for 125 tiers of rates for similar insureds. Only when a consumer actually applies will underwriting be done, and maybe the price offered is quite different than they were quoted when they actually get the policy. And, indeed, underwriting may even result with the consumer being turned away after all that. So when you shop for a can of peas, you see the unit price, all the options are before you on the shelf. When you get to the checkout counter, nobody asks where you live and turns you away. You can taste the quality as soon as you get home. You don't care if the pea company goes broke, you don't care much about their service. In short, insurance and peas are different, and that's why you need regulation.

The insurance industry promotes a myth that regulation and competition are incompatible. Regulation and competition seek the same goal, the lowest possible price consistent with a reasonable return for the seller. I assume Mr. Heller will talk about California. California relies on both regulation and competition. They maximize both, and the results have been tremendous. And auto insurance in California was the third leading state in price, highest price, when competition was replaced by Prop 103, and now they're 24th and their rates are below average in the country. It's been amazing success.

The prime issue with consumers is not who regulates insurance. Consumers could care less. It's whether insurance regulation is efficient and effective. Attached to my statement is a list of principles by which consumers will measure any proposal for regulatory reform.

As to the Federal bills, the only bill before Congress considering any of our principles is S. 1373 by Senator Hollings, and we appreciate it very much, Senator. We support the bill's prior approval mechanism, annual market conduct exams, the creation of Office of Consumer Protection, and the enhanced competition and enhanced consumer information, and the repeal of the antitrust exemption.

CFA and the entire consumer community stands ready to fight optional Federal charters with all the strength we can muster. We cannot abide a race to the bottom, which this idea is premised upon, having two systems where the industry gets to choose who regulates will drive regulation down to the bottom.

CFA would like to see a simple repeal of the McCarron-Ferguson antitrust exemption to see if insurers really are willing to compete under the same rules as American businesses.

I'd urge the Committee to continue your study of insurance regulation. The proper focus of Congress is not to encourage mindless deregulation by the states—and I'm glad to hear your statements; you don't—but to encourage greater competition and economic efficiencies while strengthening, not lowering, consumer protection standards.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hunter follows:]

PREPARED STATEMENT OF J. ROBERT HUNTER [1], DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

State of Insurance Regulation

Insurance regulation is at a crossroads. Most states are rolling back insurance consumer protections and weakening their oversight of the industry, while pressure from some insurers is growing for increased Federal regulation. Some powerful elements of the insurance industry want to be allowed to choose either Federal or state oversight (*e.g.,* ACLI, AIA, banks selling insurance). Under such an "optional Federal charter" plan, if the Federal government actually effectively regulated, these companies would be allowed to retreat to state regulation. Other elements of the industry favor no Federal role at all, except bailouts such as the Terrorism Risk Insurance Act (*e.g.,* NAII, AAI, NAMIC).

While insurance companies disagree on the need for Federal regulation, they are unanimous in their desire to use the possibility of Federal oversight as leverage to press the states to reduce extant consumer protections or hold off needed new protections. Insurers know that state regulators will want to move fast to reduce the regulatory burden (that is, the consumer protections they require) in order to hold onto some extra insurers in the regulatory turf wars that are coming. There is even talk of interstate compacts to limit regulation to one state or to otherwise "harmonize" regulation, although the states with higher standards—the sopranos, tenors and altos—will be asked to "harmonize" by learning to sing bass.

Few ask consumers what they think. I am therefore most grateful to you, Chairman McCain, Ranking Member Hollings and members of the Committee, for this opportunity to explain how insurance regulation can be improved to help consumers.

Background

Insurance is regulated by the states under a remarkable delegation of authority in the McCarran-Ferguson Act. There is no insurance oversight by the Federal government, nor are there standards for effective regulation, but there is an exemption from the antitrust law, which very few other American industries outside of major league baseball enjoy. Thus, for example, insurers routinely use rating organizations to jointly project inflation costs into the future.

Insurers have, on occasion, sought Federal regulation when the states increased regulatory control and the Federal government regulatory attitude was more lazesfaire. Thus, in the 1800s, the industry argued in favor of a Federal role before the Supreme Court in *Paul* v. *Virginia,* but the court ruled that the states controlled because insurance was intrastate commerce.

Later, in 1943 in the *SEUA* case, the Court reversed itself, declaring that insurance was interstate commerce and that Federal antitrust and other laws applied to insurance. By this time, Franklin Roosevelt was in office and the Federal government was a tougher regulator than were the states. The industry sought, and obtained, the McCarran Act.

Notice that the insurance industry is very pragmatic in their selection of a preferred regulator—they always favor the least regulation. It is not surprising that, today, the industry would again seek a Federal role at a time they perceive little regulatory interest at the Federal level. But, rather that going for full Federal control, they have learned that there are ebbs and flows in regulatory oversight at the Federal and state levels, so they seek the ability to switch back and forth at will.

Consumer organizations strongly oppose an optional Federal charter, where the regulated, at its sole discretion, gets to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections.

Further, the insurance industry has used the possibility of an increased Federal role to pressure states into gutting consumer protections over the last three or four years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections. They have been assisted in this effort by a series of House hearings, which have not focused on legislation or the need for improved consumer protection, but have served as a platform for a few politicians to issue ominous statements urging the states to further deregulate insurance oversight, "or else." (See statements by industry representatives and Members of Congress below.)

Can Insurance Be Deregulated?

There are good reasons that insurance has, historically, been subject to regulation. The most obvious one is that a consumer pays money today for a promise that may

[1] Mr. Hunter served as Federal Insurance Administrator under Presidents Ford and Carter and as Texas Insurance Commissioner.

not be deliverable for years. That promise must be secured from many threats, including insolvency and dishonesty.

No one seems to dispute the need for oversight of insurer solvency and bad management behavior. Insolvency regulation has been upgraded, thanks in large part to the interest in the issue of Warren Magnusen and John Dingell (which is how insurers first became aware of the value of Congressional pressure on state regulators.)

As front-end regulatory controls such as price regulation have been eliminated for personal lines and small businesses by the states individually and for small businesses by the actions of the National Association of Insurance Commissioners (NAIC), consumers have been promised that back-end market conduct oversight would be improved. These promises have proven to be empty. For example when small business pricing was deregulated by the NAIC and many states adopted this approach, nothing was done to correct the hopelessly incompetent market conduct system that exists in most states. (The GAO has recently documented the failures of the state market conduct system in great detail.)

The big question is: can price and product regulation be eliminated? The insurance companies say "sure," but never discuss the potential adverse impact on consumers.

Product regulation is very important for consumers. An insurance contract is a complex legal document. Consumers cannot be asked to pick out good or avoid bad deals by reading these documents. It won't happen. If insurers are free to write any contract that they want, some sharp dealers will come in with illusory policies that look good but take away the apparent coverage in the fine print. There will develop competition to write poor products that unwary consumers will buy.

Consumers are in no rush to have bad products appear in the market, even though insurers insist that "speed-to-market" is somehow a critical issue. It makes no sense to remove front-end control of these products and wait for market conduct exams or, as is more usual, lawsuits, to clean up the mess.[2]

However, consumer groups do want efficient regulation. I, and others from the consumer community, worked very hard at the NAIC to eliminate inefficient regulatory practices and delays, even helping put together a 30-day total product approval package. Our concern is not with fat cutting, it is with removing regulatory muscle when consumers are vulnerable.

Price regulation is a complex issue. It does not suffice to say that "competition is good and regulation is bad" as insurers often do.

First of all, insurance is not a normal product like a can of peas or even an auto. One cannot "kick the tires" of the complex legal document that is the insurance policy until a claim arises, perhaps years after the purchase.

Second, the level of service offered by insurers is usually unknown at the time a policy is purchased. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

Then there is the solidity of the insurance company. You can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

Finally, there is the price of the policy itself. Some insurers have many tiers of prices (we have seen mare than 25 for some companies) for similar looking insureds. Online assistance may help consumers understand some of these distinctions but only when they actually apply is full underwriting conducted. At that point, the con-

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[2] There are several reasons why it is dangerous for consumers if regulators focus exclusively on "speed to market."

First, consumers, who have been victimized by such abuses as life insurance policies that promised rates of return they could not give, consumer credit insurance policies that pay pennies in claims per dollar in premium, and race-based pricing are in no hurry for such policies. Second, in some trials of product deregulation in health insurance, policies with low prices often were found to have fine print that eliminated most coverage. Third, standards to ensure fair pricing, adequate disclosure and a more honest marketplace are urgently needed and should be a part of any process for faster product approval, particularly in the era of globalization and Internet sales. Fourth, CARFRA, a voluntary organization set up by the NAIC to offer "one-stop" approval over several states, is dangerous for consumers. CARFRA lacks direct accountability to the relevant public: consumers in affected states. There is no assurance that their standards for product approval will benefit consumers. For example, if a panel made up of Montana members approves a rate or policy for use in California, then it will be difficult for California consumers to object. CARFRA must be an independent, legally authorized entity with democratic processes, such as on-the-record voting, notice and comment rulemaking, conflict-of-interest standards, prohibitions on ex-parte communications, etc. CARFRA cannot rely on the industry it regulates to provide its funding. Moreover, the same issues consumers find dangerous in CARFRA exist in the interstate compact concept.

sumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

And, after all that, underwriting may result in the consumer being turned away.

When you shop for a can of peas, you see the unit price, all the options are before you on the same shelf, when you get to the checkout counter no one asks where you live and then denies you the right to make a purchase, you can taste the quality as soon as you get home, and you don't care if the pea company goes broke or gives much service. In short, peas are simply not insurance.

Price regulation considerations vary by line of insurance. Large commercial insureds have insurance experts, called "risk managers," on staff. They need less help from government. Individuals and small businesses may need help. They are not well informed consumers and often go into the insurance purchase decision with an odd combination of fear and boredom. They frequently go to an insurer or agent and say the something akin to "take me, I'm yours," a shopping strategy that does nothing to discipline the market price.[3]

The degree of insurance regulation that is needed varies by line-of-business, something insurers often don't admit. Consider three life insurance products as an example of this fact. Term life, cash value life and credit life. We believe that the regulatory response to these three products must be different.

Term life insurance is easy for consumers to understand. If you die in the term, whatever that time frame is, your beneficiaries receive the face amount of the policy. Consumers understand this very well so coverage is not an issue. Dead is dead, so service is not much of an issue compared to, say, auto claims. Solvency may also be somewhat less of an issue, depending upon the length of the term. The decision centers on price. Excellent online price services exist (CFA's favorite is *www.term4sale.com*).

Because of the simplicity of the decision-making process, term insurance prices are very competitive and have fallen, year-by-year, for decades. Price regulation is not needed in this line of life insurance.

Cash value insurance is a complex product. It is, essentially, a term policy with a bank account hidden inside the product. The problem is that the industry has resisted calls for tools to help consumers more easily understand what is going on inside the policy or to create suitability requirements for its agents. It is very difficult to know exactly what part of the first year premium (if any—often, it is none) goes into the bank account. CFA's actuary, who handles our service for life insurance, tells me that even he frequently can't tell a good product without running the policy details through our computerized service to see how it works. Consumers are confused. Competition is weak. Prices have not declined in the way term prices have.

For this product, prices should be subject to more control than exists today unless the industry truly agrees to stop the obfuscation and promote rules that let the consumer see what each policy is truly like.

Credit life insurance is a product sold along with a loan, such as a car loan. The car dealer may offer the coverage that would pay off a loan if an insured dies, so that this person's family would own the car outright. The problem is that consumers do not go to car dealers to buy insurance. They have not even thought about it until the dealer starts the sales pitch. If the consumer decides to buy the coverage, the consumer does not then go out and shop for an insurance company. The dealer has already done that for the consumer.

Guess what the criteria the dealer uses in making the choice of credit life insurer? The amount of the commission is, of course, the decisive factor. (Some car dealers make more money selling insurance than cars.) Prudential Insurance Company once said in a hearing in Virginia, that they did not sell much credit life insurance because "we are not competitive, our price is too low."

This purchase-of-insurance-by-the-commissioned-agent-not-the-consumer/buyer has a name: "Reverse Competition." In this line of insurance, competition drives the price up, not down.

Credit life insurance must have price regulation. States have recognized this by limiting the price that can be charged, with widely varying maxima. New York and Maine consumers pay one-fifth of the rate of Louisiana consumers, although Louisianans obviously do not die five times faster than Mainers. Even though the credit life insurers, car dealers and other powerful lobbyists have succeeded in keeping the price outrageously high in most states, at least there are caps in every state, as there must continue to be.

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[3] Another problem with insurance is the inertia of consumers. That is, the reluctance to change carriers for even fairly large price breaks. Consumers fear that new insurers would be more apt to drop them after a claim than their old insurer. This inertia is a drag on the competitive force of consumer decisions.

Is Regulation Incompatible With Competition?

The insurance industry promotes a myth: regulation and competition are incompatible. This is demonstrably untrue. Regulation and competition both seek the same goal: the lowest possible price consistent with a reasonable return for the seller. There is no reason that these systems cannot coexist and even compliment each other.

The proof that competition and regulation can work together in a market to benefit consumers and the industry is the manner in which California regulates auto insurance under Proposition 103. Indeed, that was the theory of the drafters (including me) of Proposition 103. Before Prop. 103, Californians had experienced significant price increases under a system of "open competition" of the sort the insurers seek. (No regulation of price is permitted but rate collusion by rating bureaus is allowed, while consumers receive very little help in getting information, etc.) Prop. 103 sought to maximize competition by eliminating the state antitrust exemption, laws that forbade agents to compete, laws that prohibited buying groups from forming, and so on. It also imposed the best system of prior approval (of insurance rates and forms) in the nation, with very clear rules on how rates would be judged.

As our in-depth study of regulation by the states revealed,[4] California's regulatory transformation—to rely on both maximum regulation and competition—has produced remarkable results for auto insurance consumers and for the insurance companies doing business there. The study reported that insurers realized very nice profits, above the national average, while consumers saw the average price for auto insurance drop from $747.97 in 1989, the year Proposition 103 was implemented, to $717.98 in 1998. Meanwhile, the average premium rose nationally from $551.95 in 1989 to $704.32 in 1998. California's rank dropped from the third costliest state to the 20th.

I can update this information through 2001.[5] As of 2001, the average annual premium in California was $688.89 (Rank 23) vs. $717.70 for the Nation. So, from the time California went from reliance simply on competition as insurers envisioned it to full competition and regulation, the average auto rate fell by 7.9 percent while the national average rose by 30.0 percent. A powerhouse result!

State Regulatory/Legislative Failures

Compare the outstanding improvement in consumer protection in California with the collapse of regulatory resolve at the national, NAIC level. Here is a small sample of NAIC failures and consumer protection rollbacks:

Failures To Act

1. Failed to do anything about abuses in the small face life market. Instead, they adopted an incomprehensible disclosure on premiums exceeding benefits, but did nothing on overcharges, multiple policies, or unfair sales practices.
2. Failure to do anything meaningful about unsuitable sales in any line of insurance. Suitability requirements still do not exist for life insurance sales even in the wake of the remarkable market conduct scandals of the late 1980s and early 1990s. A senior annuities protection model was finally adopted (after years of debate) that is so limited as to do nothing to protect consumers.
3. Failure to call for collection and public disclosure of market performance data after years of requests for regulators to enhance market data, as they weakened consumer protections. How do you test if a market is workably competitive without data on shares by zip code and other tests?
4. Failure to do anything as an organization on the use of credit scoring for insurance purposes. In the absence of NAIC action, industry misinformation about credit scoring has dominated state legislative debates. NAIC's failure to analyze the issue and perform any studies on consumer impact, especially on lower income consumers and minorities, has been a remarkable dereliction of duty.
5. Failure to address problems with risk selection. There has not even been a discussion of insurers explosive use of underwriting and rating factors targeted at socio-economic characteristics: credit scoring, check writing, prior bodily injury limits, prior insurer, prior non-standard insurer, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.

[4] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," June 6, 2000; *www.consumerfed.org.*).

[5] *State Average Expenditures & Premiums for Personal Automobile Insurance in 2001,* NAIC, July 2003.

6. Failure to do anything on single premium credit insurance abuses.
7. Nothing has been done on redlining or insurance availability or affordability. The vast majority of states no longer even look at these issues, 30 years after the Federal government issued studies documenting the abusive practices of insurers in this regard. Yet, ongoing lawsuits continue to reveal that redlining practices harm the most vulnerable consumers.

Rollbacks of Consumer Protections

1. The NAIC pushed through small business property/casualty deregulation, without doing anything to reflect consumer concerns (indeed, even refusing to tell us why they rejected our specific proposals) or to upgrade "back-end" market conduct quality, despite promises to do so.
2. As a result many states adopted the approach and have rolled back their regulatory protections for small businesses. Nebraska and New Hampshire joined the list of states that have deregulated just this year.
3. States are rolling back consumer protections in auto insurance as well. Just this year, New Jersey, Texas, Louisiana, and New Hampshire did so.
4. The NAIC just terminated free access for consumers to the annual statements of insurance companies at a time when the need for enhanced disclosure is needed if price regulation is to be reduced.

NCOIL: At the Insurance Industry's Beck and Call

As bad as the NAIC and some state regulators have been, the National Conference of Insurance Legislators is worse. NCOIL is directed by a significant number of legislators who work for the insurance industry.[6] On several issues that are currently being debated in Congress and the states, NCOIL has offered recommendations that would negatively affect many insurance consumers, recommendations that often mirror insurance industry proposals.

For example, on May 6, 2003 Illinois State Senator and insurance agent Terry Parke offered Congressional testimony on NCOIL's proposals to improve oversight of "market conduct" abuses by insurance companies. Parke's written testimony did not comment on the state regulatory failures that led to well-known market conduct abuses that cost consumers millions of dollars, such as the infamous life insurance market conduct abuses by the Nation's largest insurers such as Prudential and Met Life. Instead, Parke offered recommendations that would allow insurance companies to "self certify" that they are complying with market conduct requirements and would largely restrict oversight of insurance companies to the state where the company is headquartered.

In the wake of the Enron and WorldCom scandals, we are astonished that NCOIL would propose allowing insurance companies to essentially regulate themselves. Even worse, NCOIL proposes to put the state that is most subject to political pressure—the state where an insurance company is based—in charge of market conduct regulation for that company.

NCOIL has also offered model legislation on the use of credit scoring for insurance purposes, which has been adopted by several states. The legislation would allow insurers to continue to use credit scores to grant insurance policies and establish rates, even though serious concerns have been raised about the logic of using credit history to predict consumer accident propensity (why would getting laid off in a recession make a person a bad driver?), the inaccuracy of these scores, and the disproportionate impact that this practice has on low income and minority consumers. NCOIL's model bill would only ban the use of credit scoring if it is the *sole* factor used in the underwriting or pricing of insurance, which means that the bill offers no protection, as credit scoring is never the sole factor used for these purposes.

The NCOIL credit-scoring bill was developed at the behest of the industry, which realized that real reform might emerge as consumers across the Nation expressed outrage over higher prices due to consideration of irrelevant credit histories. The NCOIL vote on this was telling. Members from five states (MI, NY, VT, ND and LA) accounted for 60 percent of the vote. Members from North Dakota represented 8 percent of the vote (its population is 0.2 percent of the national population). At least seven of the 25 members on the NCOIL committee that proposed this legislation are employed by the insurance industry. The vote does not appear to be representative of much other than insurer wishes.

While not every proposal NCOIL offers is anti-consumer, many are. Other examples of recent anti-consumer moves by NCOIL include:

[6] "Many State Legislators Involved with National Insurance Organization Have Close Ties to Insurance Industry," CFA, 07/09/03 (at www.consumerfed.org).

- After years of effort, consumer groups persuaded the NAIC to adopt a credit personal property insurance model bill with a 60 percent loss ratio standard, which is necessary because credit insurance is added to a sale of some other products with huge, often hidden commissions being paid to the seller. Because the seller selects the insurer, not the customer, credit insurance suffers from "reverse competition," driving prices up. Thus a loss ratio limit is vital to control cost. A short time after NAIC acted to control the loss ratio, the industry went to NCOIL, which had never worked on the issue, and got them to issue a resolution opposing the loss ratio standard. If NCOIL prevails, consumers who purchase this form of credit insurance will pay millions of unnecessary dollars.
- Consumers requested that NCOIL adopt a consumer participation program, like that sponsored by NAIC, in which a few consumer representatives can come to the meetings to present consumer positions. NCOIL would cover participants' expenses, with consumer groups supplying the time of their advocates. Not only did NCOIL reject this mechanism for allowing consumer input, they also voted down the more modest measure of waiving registration fees for consumers, effectively shutting out all consumer input from their meetings.
- NCOIL adopted a property/casualty insurance regulatory model bill that is intended to cut consumer protections by reducing regulatory authority. The model goes so far as to say that the model should not be adopted if a state has gone even further in removing consumer protections than the bill proposes, *i.e.,* the model is only recommended for use when it lowers protection but is not recommended for use if it raises protections. The model does not require the insurer to even file rate increases with an insurance commissioner until 30 days after it begins to charge consumers more. The commissioner, under the model, could not disapprove even an excessive rate if the market was "competitive" under a set of standards that would make a finding of non-competitiveness nearly impossible.
- NCOIL's Insurance Compliance Self Evaluation Privilege Model Act would give insurers a privilege of secrecy for anything they claim as "self-audit", effectively allowing the industry to shield itself from responsibility for its market conduct actions.

What has Caused the States to Move So Suddenly to Cut Consumer Protections Adopted Over a Period of Decades?

In a word, "pressure," from insurers and from a couple of Members of Congress.

Industry Statements

What follows are examples of industry attempts to use the Federal government interest in insurance to pressure the NAIC into action:

1. The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the Federal option and that their huge effort of 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem the tide. In a July 9, 2001 *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." His remarks were so offensive that I went up to several top commissioners immediately afterwards and said that Materra's speech was the most embarrassing thing I had witnessed in 40 years of attending NAIC meetings. I was particularly embarrassed since no commissioner challenged Mattera and many had almost begged him to grant them more time to deliver whatever the industry wanted.
2. Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds." So other observers of the NAIC see this pressure as potentially damaging to consumers.
3. Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the *National Underwriter* of June 4, 2000. In it he said, ". . . how long will Congress and our own industry watch and wait while our competitors[7] continue to operate in a more uniform and less burdensome regulatory environment? Momentum for Federal regulation

[7] Of course, Mr. Forrester knows that this is a life insurer problem, which is not the case for his members, who are property/casualty insurance companies.

appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the Nation's capital . . . NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely . . . The long knives for state regulation are already out . . ."

4. In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control" dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) . . . others in the financial services industry—including insurers—will aggressively pursue Federal regulation of our business . . ."

Congressional Statements

The leading Member of Congress involved in putting pressure on the states to further deregulate is House Financial Services Committee Chairman Michael Oxley. Below are some recent statements Chairman Oxley has made on the matter.

"Make no mistake about it, true reform is necessary. *It is my hope that our State legislators and insurance commissioners can enact such reform. If not, Congress will return to this issue with our own solution.*" (Emphasis added) Opening statement at 6/2/01 Hearing, "Insurance Product Approval: The Need for Modernization."

". . . why are Massachusetts and New Jersey afraid to adopt the models used successfully in Illinois and now South Carolina . . ." Opening statement at 8/1/01 Hearing, "Over Regulation of Automobile Insurance: A Lack of Consumer Choice."

". . . price fixing and heavy anti-consumer regulations . . . have led to a balkanized system that can be inefficient, denies consumers choice, and is destroying the industry's competitive ability to raise capital. Today . . . we turn from assessing the current inefficiencies to a review of the various proposals for reform. Consensus will be difficult, but America deserves our every effort . . ." Opening statement at 6/4/02 Hearing, "Insurance Regulation and Competition for the 21st Century" (Day 1).

". . . our American insurance marketplace is entering into a crisis . . . Some states fix prices below the levels to attract adequate capital . . . And each state imposes its own regulatory regime, creating long delays for consumers, and making it impossible for insurers to provide products uniformly nationwide . . . It is my primary hope that our State legislators and insurance commissioners can enact meaningful reform. The States have had some success . . . I would note however that this *success is far from complete and has only occurred in the face of Congressional legislative pressure, pressure that will continue to grow if the pace of reform does not improve.* (Emphasis added) Opening statement at 6/11/02 Hearing, "Insurance Regulation and Competition for the 21st Century" (Day 2).

"As many of you know, my interest in reform is not new. Several years ago I asked the NAIC to focus on this glaring problem and they responded in March, 2000 with a Statement of Intent . . . Since that time, the NAIC has experienced some successes and some failures. In the face of Congressional legislative pressure, the NAIC has made progress in agent licensing reform . . . Unfortunately, the NAIC has met with less success in efforts to modernize the product approval process . . . Unfortunately, it is becoming increasingly apparent that the NAIC may be facing an insurmountable task . . . this Committee will not sit idly by. I am committed to working on this issue for the long haul, looking at all the different facets of the industry. We will keep building . . . we will not let up . . ." Opening statement at 6/18/02 Hearing, "Insurance Regulation and Competition for the 21st Century" (Day 3).

". . . a problem that has reached crisis proportions in some States: the increasing difficulty consumers face in finding available insurance for their homes and cars . . . (a) crisis being caused in part by the archaic system of insurance price controls imposed by some states . . . wrong-headed regulation . . ." Opening statement at 4/10/03 Hearing, "The Effectiveness of State Regulation: Why Some Consumers Can't Get Insurance."

"I believe that we're reaching agreement on the fundamental nature of the problem and are nearing agreement on a framework to fix it . . . *We will be discussing a number of short-term legislative proposals to fix the state system later this year, and hope that the states can act quickly . . . before Congress needs to step in and provide additional impetus. (Emphasis added)* Opening statement at 5/6/03 Hearing "Increasing the Effectiveness of State Consumer Protections."

Consumers Don't Care Who Regulates—It's The Quality Stupid!

The prime issue with consumers is not who regulates insurance; it is whether insurance regulation is effective and efficient.

As a former state regulator, I have always supported state regulation of insurance, but now that I see the ease in which states panic and are willing to trade consumer protections to protect their turf, I am reevaluating my life-long support. CFA intends, over the next few months, to meet with consumer, business, labor and other interests to determine whether CFA should end its support of state regulation.

We have already determined one thing: optional Federal charter legislation is harmful to consumers. The writers of these bills have readily admitted to me, to their credit, that their intent is to set up a "race to the bottom" where, in a search for regulatory market share, regulators will compete with each other to attract insurers by lowering consumer protections. Consumers can not allow this race to get started anymore than insurers would agree to a system where consumers could vote to decide which regulator would oversee the insurance industry (creating a race in the other direction).

When the NAIC began its process to head off Federal oversight, consumer groups came together to write a white paper to list the consumer protections we sought. That paper, "Consumer Principles and Standards for Insurance Regulation," is attached to this statement. It presents the principles by which consumers will measure any proposal for insurance regulatory reform, be it state or federally based.

Federal Options

At the moment, Federal regulatory options include the Hollings Bill, the optional Federal charter idea espoused by part of the insurance industry, a simple bill that would repeal the antitrust exemption combined with oversight of the delegation of insurance regulation to the states and, perhaps, minimum standards for regulatory effectiveness and efficiency.

Hollings Bill

Only one bill before Congress considers the consumer perspective in its design, adopting many of the proposals made in our white paper. That is S. 1373 by Senator Hollings.

The bill would adopt a unitary Federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

The bill's regulatory structure requires Federal prior approval of prices to protect consumers, including some of the process language (such as hearing requirements when prices change significantly) so effectively used in Prop. 103. It requires annual Market Conduct exams. It creates an office of consumer protection. It enhances competition by removing the antitrust protection insurers hide behind in ratemaking. It improves consumer information and creates a system of consumer feedback.

S. 1373 is a good bill and should be the baseline for any debate on the subject before this committee.

Optional Federal Charter

The bills that have been proposed would create a Federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market for a particular line of insurance might be. These bills represent the wish list of insurer interests, and include minimal, if any, regulation, coupled with little improvement in consumer information or protection systems.

As stated above, the bills put forth by the industry are an amazing attempt to play off the Federal government against the states. For consumers, these bills are poison and cannot be fixed. If these elements of the industry truly want to obtain "speed to market" and other advantages through a Federal regulator, let them propose a Federal approach that does not allow insurers to run back to the states when regulation gets tougher. We can all debate the merits of that approach.

CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

Amend the McCarran Act to Provide Federal Oversight and, Perhaps, Minimum Standards for Efficient and Effective Regulation

Insurers want competition to set rates, they say. How about a simple repeal of the antitrust exemption in the McCarran Act to test their desire to compete under the same rules as normal American businesses do? We will then see just how much they want competition.

Another amendment to the McCarran Act we would suggest is to do what should have been done at the beginning of the delegation of authority to the states—have the FTC and other Federal agencies perform scheduled oversight of the states' regulatory performance and propose minimum standards for effective and efficient consumer protection. The Hollings bill or the provisions of Prop. 103 might be the basis for such minimum standards.

Conclusion

Insurers talk a good competition game, but they do not walk it. Rarely will those calling for deregulation seek to give up the antitrust exemption or increase the provision of consumer information or do the other things needed to make competition effective. Insurers seek to set up systems designed to make dual regulators fight with each other for market share by weakening consumer protections; never proposing strong regulatory floors to avoid such a result. Most insurers do not seem to want effective and efficient regulation. Rather they appear to want no regulation.

Insurers seek to continue to use Congress to pressure the states into giving up necessary consumer protections out of fear of loss of regulatory turf. To date, the pressure on the states from the Hill has come primarily from a few Members of Congress not in this body. I strongly urge you to resist engaging in such activity because it is a detriment the needs of your constituents.

I urge the Committee to continue your study of insurance regulation. The proper focus of Congress is not to encourage mindless deregulation by the states, but to encourage greater competition and economic efficiencies while strengthening, not lowering consumer protection standards.

Thank you for the opportunity to appear here today. I will be happy to answer your questions at the appropriate time.

CONSUMER PRINCIPLES AND STANDARDS FOR INSURANCE REGULATION

1. Consumers should have access to timely and meaningful information of the costs, terms, risks and benefits of insurance policies.

- Meaningful disclosure prior to sale tailored for particular policies and written at the education level of average consumer sufficient to educate and enable consumers to assess particular policy and its value should be required for all insurance; should be standardized by line to facilitate comparison shopping; should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); should address non-English speaking or ESL populations.
- Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, *e.g.,* seniors, low-income, low education.
- Disclosure should be made appropriate for medium in which product is sold, *e.g.,* in person, by telephone, on-line.
- Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, *e.g.,* a scale based on insurer filings developed by insurance regulators or independent third party.
- Non-term life insurance policies, *e.g.,* those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
- Free look period with meaningful state guidelines to assess appropriateness of policy and value based on standards the state creates from data for similar policies.
- Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (*e.g.,* policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
- Significant changes at renewal must be clearly presented as warnings to consumers, *e.g.,* changes in deductibles for wind loss.
- Information on claims policy and filing process should be readily available to all consumers and included in policy information.
- Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, *e.g.,* life and credit.
- Consumer Bill of Rights, tailored for each line, should accompany every policy.
- Consumer feedback to the insurance department should be sought after every transaction (*e.g.,* after policy sale, renewal, termination, claim denial). Insurer should give consumer notice of feedback procedure at end of transaction, *e.g.,* form on-line or toll-free telephone number.

2. Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.

- Disclosure requirements above apply here as well and should be included in design of policy and in the policy form approval process.
- Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, *e.g.,* the actual current and future cost, including commissions and penalties.
- Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurers are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
- "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
- Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, *e.g.,* action to limit credit insurance rates.

3. All consumers should have access to adequate coverage and not be subject to unfair discrimination.

- AWhere coverage is mandated by the state or required as part of another transaction/purchase by the private market, *e.g.,* mortgage, regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. Zip code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authority for review and made public.
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, *e.g.,* redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, reviews of all forms of underwriting instructions, including oral instructions to producers.
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.

- Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, *e.g.,* if companies only offer better rates, etc. online.
- Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
- Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable)
- In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent

technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.

- A regulatory entity, on its own or through delegation to independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. Consumers should have control over whether their personal information is shared with affiliates or third parties.

- Personal financial information should not be disclosed for other than the purpose for which it is given unless the consumer provides prior written or other form of verifiable consent.
- Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
- Consumers should not be denied policies or services because they refuse to share information (unless information needed to complete transaction).
- Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
- Insurance companies should have clear set of standards for maintaining security of information and have methods to ensure compliance.
- Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to sharing of the data.
- Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (*e.g.,* a worker should get privacy protection under workers' compensation).

6. Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.

- Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, *e.g.,* the reauthorization of FTC.

7. Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.

- Insurance regulators must have clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (*e.g.,* market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups

to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.

- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Insurance departments should support strong patient bill of rights.
- Focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within regulatory body should be established for education and outreach to consumers, including providing:
- Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
- Access to information sources should be user friendly.
- Counseling services to assist consumers, *e.g.,* with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, *i.e.,* the NAIC database.
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, *e.g.,* help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to regulatory entity must be subject to judicial review with burden of proof on insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, *e.g.,* rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
- Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of “Consumer Alerts” should be established by the regulators, *e.g.,* companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legisla-

tors accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.

- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in status of insurance companies (*e.g.,* demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies or "one-stop" (OS) approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the OS state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have well-established structure for ongoing dialogue with and meaningful input from consumers in the state, *e.g.,* consumer advisory committee. This is particularly true to ensure needs of certain populations in state and needs of changing technology are met.

The CHAIRMAN. Mr. Ahart?

STATEMENT OF THOMAS AHART, PRESIDENT, AHART, FRINZI & SMITH INSURANCE AGENCY, ON BEHALF OF AND PAST PRESIDENT, INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

Mr. AHART. Yes, good morning, Chairman McCain and Ranking Member Hollings and Senate Committee Members.

I'm Tom Ahart, and I'm an insurance agent, own an agency in Phillipsburg, New Jersey, and I'm a past President of the Independent Insurance Agents & Brokers of America. I appreciate the opportunity for us to testify and to be involved in the process of revamping insurance regulation.

Over the last 10 years, as an insurance agent, we've really seen a change with technology and with global modernization, which has changed our industry. Many of our business accounts that we now write don't just do business in New Jersey, they do business across the country and internationally, and it's very important to have products that can meet those needs and be able to be licensed in different states to handle their needs as they change.

Since Gramm-Leach-Bliley was passed, there have been a few insurance companies, both domestic and international, that have called for Federal regulation of insurance to change from the current state-based system because they've seen a need to help certain problems, like speed-to-market issues and licensing issues, which they felt weren't being addressed by the state system.

As agents, we recognize those problems. We believe that there are major problems right now in speed-to-market issues and in license uniformity. It's very difficult as agents and as insurance companies that we represent to provide some of the new products and get them passed. For instance, e-commerce products that are coming up daily are difficult to get passed at times in different states

when we need them. It's very difficult, even though with the licensing modernization laws that have been passed and the work with the NAIC, it's still difficult in some states to get licensed on a timely basis, and, therefore, it's tough to provide the protection that we need for our insurance consumers.

So we recognize those issues, and I think in most of the testimony you'll hear, you'll hear that there are problems with speed to market and with licensing issues, and we agree with that.

However, recognizing those problems, we don't believe that the answer is Federal regulation. We believe that it's an unproven system, and we also believe that it's total overkill. There are many things that the state regulatory system has done well over the 150 years that it's been in existence. It's involved with regulation of coverage parameters, it involves regulation of sales practices, claims practices, claims dispute situations, and those things have been handled very, very well at the state level. So to change that because there are certain issues that aren't working well just doesn't make sense.

So the Independent Insurance Agents & Brokers of America have been working on a draft with a lot of insurance leaders. We've met with NAIC and talked with them and gotten their input, as well as insurance companies and other agents' organizations, and we've really come up with what we think is a pragmatic middle-of-the-road approach, in that instead of going to Federal regulation, we believe we should use legislative tools, basically Federal legislation, just to handle those issues that are a problem at the time. For instance, on speed-to-market issues there could be Federal legislation that's passed that actually preempts state rights and allows file-and-use laws. So on forms, we would recommend that file-and-use be handled so that forms would be filed 30 days prior, and there would be 30 days to approve those forms. If there's nothing heard at the end of 30 days, it would be deemed to be approved, and that would hurt—that would help the speed-to-market issue in forms.

In rates, we believe that it should be pretty much market competition, and in those areas of the market that are competitive, we believe that we should allow it to be a competitive situation and not be regulated as far as the rates go. We believe, in those markets that are not competitive, that the states should still regulate those areas to make sure that the coverages are still available.

As far as licensing goes, we believe in more uniformity and reciprocity, and we think that, again, that can be handled on a Federal legislation basis by, again, preempting state rights so that uniformity and reciprocity is mandated, and then the states would be the ones that would regulate it once the law has been passed.

And, in essence, a company and an insurance agent would be licensed in their state, and then once they've met those licencing requirements, they'd be able to get nonresident licenses by, again, simply meeting their own standards in their own states and filing once.

So we believe that there is a lot of opportunity to handle the issues as they come up by using Federal tools; however, it just doesn't make sense to us in any way to overkill and to go to situations on Federal regulations which are unproven and which would

actually hurt areas of consumer protection that are currently being done by state regulation.

In addition, it would create a huge Federal bureaucracy, in our mind. In those areas where you'd have Federal and state regulation, it would create a dual bureaucracy, you know, for agents. We represent many companies, small and large, and we would end up having to be licensed both at the state level and the Federal level as companies chose which regulation they wanted to follow.

So, in conclusion, we believe strongly in continuing state regulation, but using legislative tools, basically Federal legislation, to handle just those issues that seem to be a problem.

Thank you very much.

[The prepared statement of Mr. Ahart follows:]

PREPARED STATEMENT OF THOMAS AHART, PRESIDENT, AHART, FRINZI & SMITH INSURANCE AGENCY, ON BEHALF OF AND PAST PRESIDENT OF INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

Good afternoon Chairman McCain, Ranking Member Hollings, and members of the Committee. My name is Tom Ahart, and I am pleased to have the opportunity to give you the views of the Independent Insurance Agents & Brokers of America (IIABA) on the current state of insurance regulation and IIABA's views on the role Congress can play to reform and improve the current system. I am President of the Ahart, Frinzi & Smith Insurance Agency in Phillipsburg, New Jersey. I am also a past President of the IIABA.

IIABA is the Nation's oldest and largest national trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers and agency employees nationwide. IIABA members are small, medium and large businesses that offer customers a choice of policies from a variety of insurance companies. Independent agents and brokers offer all lines of insurance—property, casualty, life, health, employee benefit plans and retirement products.

Introduction

At the outset, Chairman McCain, I must note that IIABA applauds the Committee's interest in this issue as we have many challenges facing the state-based system of insurance regulation. It is our expectation that this hearing will be the first step in what promises to be a comprehensive and ongoing process, and we hope we will have the opportunity to present our views at each and every stage of your deliberations on these crucial questions.

In the last few years, the perceived need for reform has increased. The enactment of financial services modernization legislation and the emergence of an increasingly more consolidated, more global financial services industry have sparked new interest in the concept of an "optional" Federal insurance charter and, more generally, in Federal regulation of the business of insurance. Proponents of such proposals argue that Federal insurance regulation would promote greater uniformity, reduce costs and cause less frustration than the current multi-state system.

IIABA believes it is essential that all financial institutions be subject to efficient regulatory oversight and that they be able to bring new and more innovative products and services to market quickly to respond to rapidly evolving consumer demands. It is clear that there are deficiencies and inefficiencies that exist today, and there is no doubt that the current state-based regulatory system should be reformed and modernized. At the same time, however, the current system is exceedingly proficient at insuring that insurance consumers—both individuals and businesses—receive the insurance coverage they need and that any claims they may experience are paid. These aspects of the state system are working well, and I have little doubt that this Committee will hear any testimony to the contrary. The optional Federal regulation proposals, however, would displace these well-running components of state regulation as well and, in essence, thereby "throw the baby out with the bathwater."

As we have for over 100 years, IIABA supports state regulation of insurance—for all participants and for all activities in the marketplace. Yet despite this historic and longstanding support, we are not confident that the state system will be able to resolve its problems on its own. In fact, we feel there is a vital role for Congress to play in helping to reform the state regulatory system, and such an effort need

not replace or duplicate at the Federal level what is already in place at the state level. We propose that two overarching principles should guide any such efforts in this regard. First, Congress should attempt to fix only those components of the state system that are broken. Second, no actions should be taken that in any way jeopardize the protection of the insurance consumer, which is the fundamental objective of insurance regulation.

Under the proposal that IIABA has been developing in conjunction with a broad-based group of insurers and insurance producers, these overarching principles would be satisfied through an approach under which—

(1) Every insurer, agent and broker would be subject to only a single—albeit a state—regulator for licensing determinations, solvency regulation, financial audits, corporate transaction reviews and corporate governance requirements;
(2) The procedures under which states review proposed insurance policy forms would be limited to 30 days, and the requirements that apply to rate approvals essentially would be eliminated for any insurance coverage sold in a "competitive" marketplace; and
(3) Although no substantive consumer protection requirements would be eliminated or displaced, incentives for states to create compacts to streamline the market conduct examination process would be provided and limitations would be placed on the ability of state regulators to conduct "fishing expedition"-type examinations.

To explain the rationale under girding this approach, I will first offer an overview of both the positive and the negative elements of the current insurance regulatory system. I will then provide a more complete explanation of IIABA's proposal to address the negative while retaining the positive elements of the current system.

1. The Current State of Insurance Regulation

As the United States Supreme Court has so aptly put it, "[p]erhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States."[1] "It is practically a necessity to business activity and enterprise."[2] Insurance serves a broad public interest far beyond its role in business affairs and its protection of a large part of the country's wealth. It is the essential means by which the "disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired."[3] Thus, it is "the conception of the lawmaking bodies of the country without exception that the business of insurance so far affects the public welfare as to invoke and require governmental regulation."[4] Since the inception of the business of insurance in the United States, it is the states that have carried out that essential regulatory task. Today, state insurance departments employ over 11,000 individuals and address hundreds of thousands of consumer complaints and inquiries annually, and they draw on over a century-and-a-half of regulatory experience they endeavor to protect the insurance consumers of this country.

These core regulatory tasks of state insurance regulators can essentially be divided into the following eight categories:

(1) Regulation of the coverage parameters of insurance contracts;
(2) Sales practices regulation;
(3) Claims practices regulation;
(4) Claims dispute mediation/resolution;
(5) Claims payment guarantees—state guaranty funds regulation and solvency regulation;
(6) Claims payment guarantees—qualification standards and financial audits;
(7) Insurer licensing, merger review and corporate governance regulation; and
(8) Insurance agent/broker licensing and qualifications to do business regulation.

As a general matter and as explained in more detail below, the regulatory performance of the state system on the first five of the eight categories—all of which directly involve regulation of the interaction between the consumer and the insurer—is superlative. It is only with respect to determining and monitoring insur-

[1] *United States* v. *South-Eastern Underwriters Ass'n,* 322 U.S. 533, 540 (1944).
[2] *German Alliance Ins. Co.* v. *Lewis,* 233 U.S. 389, 415 (1914).
[3] *Id.* at 413.
[4] *Id.* at 412.

ers, agents, and brokers' qualifications to do business and financial health that the state system has developed the inefficiencies that are now the focal point of the cries for reform.

a. The Positive—Protecting Consumers and Ensuring Claims Are Paid

The goal of all insurance is to protect the purchaser (or their heirs) from calamity. At its most basic level, this means that the consumer purchases an insurance contract and, in exchange for the premium paid for that contract, the consumer receives a promise from the insurance company that they will be compensated for any losses they experience that are covered under that contract. From the consumer perspective, it is imperative that the insurance contract be adequate for their needs and that the insurer actually pay any claims that are made under that contract. In both of these respects, the historical performance of state insurance regulators is impeccable—they ensure that necessary coverage minimums are included in insurance contracts and, perhaps even more importantly, they make sure legitimate claims are paid.

Regulators play two very distinct roles in ensuring that claims are paid. First, they are responsible for guaranteeing that funds are available to pay any and all claims that arise. Despite their best efforts to oversee and audit insurers' financial solvency, insurance companies—like national banks and savings and loans—sometimes fail. The state system of insurer guaranty funds—which are like Federal Deposit Insurance Corporation (FDIC) insurance but for insurance companies instead of banking institutions—works. It has paid out over $11 billion to cover claims asserted against insolvent insurers since they were first created in the mid-1970s, and none of that money has been at taxpayer expense.

Second, state regulators play a vital role in mediating disputes that arise on a daily basis between consumers who have submitted claims and insurers who contend that the claims either are illegitimate or are not covered by the insurance policy. The respective bargaining positions between tens of millions of insureds—such as individuals and small businesses—and their insurers is tremendously skewed. Insurance consumers therefore regularly rely on the intervention of state regulators on their behalf when claims disputes arise. Large segments of every insurance department in the country are dedicated to assisting with the resolution of such disputes, and all available evidence suggests that insurance consumers are very satisfied with those local efforts.

b. The Negative—Product Regulation and Duplicative Oversight

As you will hear from the testimony give today, it becomes evident that all of the perceived shortcomings of state regulation of insurance fall into two primary categories—it simply takes too long to get a new insurance product to market, and there is unnecessary duplicative regulatory oversight in the licensing and post-licensure auditing process.

In many ways, the "speed-to-market" issue is the most pressing and the most vexing from both a consumer and an agent/broker perspective because we all want access to new and innovative products that respond to identified needs. The reality of today's marketplace is that banking institutions and securities firms are able to develop and market new and more innovative products and services quickly, while insurance companies are hampered by lengthy and complicated filing and approval requirements in 50 states. As a result, insurance companies—and, derivatively, agents and brokers selling their products and services—are at a competitive disadvantage compared to their counterparts in other financial services industries.

Today, insurance rates and policy forms are subject to some form of regulatory review in nearly every State, and the manner in which rates and forms are approved and otherwise regulated can differ dramatically from state to state and from one insurance line to the next. While most insurance codes provide that policy rates shall not be inadequate, excessive or unfairly discriminatory, and that policy forms must comply with state laws, promote fairness, and be in the public interest, there are a multitude of ways in which States currently regulate rates and forms. These systems include prior-approval, flex-rating, file-and-use, use–and-file, competitive-rating and self-certification. These requirements are important because they not only affect the products and prices that can be implemented, but also the timing of product and rate changes in today's competitive and dynamic marketplace.

The current system, which may involve seeking approval for a new product or service in up to 55 different jurisdictions, is too often inefficient, paper intensive, time-consuming, arbitrary and inconsistent with the advance of technology and regulatory reforms made in other industries. As you have heard previously, it often takes two years or more to obtain regulatory approval to bring new insurance products to market on a national basis. Cumbersome inefficiencies create opportunity

costs, and the regulatory regime in many states is likely responsible for driving many consumers into alternative markets mechanisms. As a result, the costs of insurance regulation are exceeding what is necessary to protect the public, particularly in the area of commercial insurance. In order to keep insurers competitive with other financial services entities and maximize consumer choice in terms of the range of products available to them, changes and improvements are needed.

Similarly, insurers are required to be licensed in every state in which they offer insurance products, and the regulators in those states have an independent right to determine whether an insurer should be licensed, to audit its financial solvency and market-conduct practices, to review mergers and acquisitions, and to dictate how the insurer should be governed. With the exception of market-conduct examinations, it is difficult to discern how the great cost of this duplicative regulatory oversight is justified, especially in light of the fact that the underlying solvency requirements are essentially identical from state to state. Market conduct examinations present a somewhat more thorny issue because, although the majority of sales and claims practices requirements and prohibitions are similar across the country, there are local variations. It is, of course, difficult for a regulator to determine compliance with another jurisdiction's requirements. At the same time, it seems wholly unnecessary for each regulator to examine every insurer on every aspect of their compliance practices given that there is such an extensive overlap in requirements.

2. Solutions

Although heroic efforts have been made to date, state regulators and legislators face the near impossible challenge of addressing and remedying the identified deficiencies unilaterally. For the most part, these reforms must be made by statute, and state lawmakers face practical and political hurdles and collective action challenges in their pursuit of such improvements on a national basis. Despite the actions of the States on producer licensing reform over the last two legislative sessions, real-world realities suggest that it is extraordinarily difficult, if not impossible, to pass identical bills through the 50 state legislatures

Although the proposed optional Federal regulation proposals might correct certain deficiencies, the cost is incredibly high. The new regulator would serve to add to the overall regulatory infrastructure—especially for agents and brokers selling on behalf of both state and federally regulated insurers—and undermine sound aspects of the current state regulatory regime. The best characteristics of the current state system from the consumer perspective would be lost if some insurers were able to escape state regulation completely in favor of wholesale Federal regulation. Federal models propose to charge a distant and likely highly politicized Federal regulator with the implementation and enforcement of a single set of rules that would apply equally across all States and all insurance markets. Such a distant Federal regulator may be completely unable to respond to insurance consumer claims concerns and its mere creation could spark fears that this will prove to be the case. Nor can a single regulatory system harmonize the diversity of underlying state reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation. The potential responsiveness of a Federal regulator to both industry and consumer needs in several critical areas could therefore jeopardize the fundamental purpose of insurance regulation and must be considered questionable at best.

This year, Sen. Fritz Hollings (D–S.C.) has introduced the Insurance Consumer Protection Act (S. 1373). This legislation takes a very dramatic approach by proposing to repeal the McCarran-Ferguson Act. In addition, S. 1373 would create a "Federal Insurance Commission," an independent panel within the Department of Commerce. The commission would be the sole regulator of all interstate insurers offering property and casualty insurance as well as life insurance. As with any proposal that would shift regulation from the states to the Federal Government, IIABA strongly opposes this legislation.

There are several key components to S. 1373 that IIABA strongly objects to. Under this legislation, a newly formed commission would have full authority over both rates and policies, while at the same time allowing consumers to have a right to challenge rate applications before the Commission. The commission would also be responsible for licensing and standards for the insurance industry, annual examinations and solvency reviews, investigation of market conduct, and the establishment of accounting standards. The bill would also allow the Commission to investigate the organization, business, conduct, practices and management of "any person, partnership or corporation in the insurance industry." It would appear that insurance agents and brokers would fall under this definition. IIABA believes that by creating this commission, S.1373, would only take everything that is wrong with the current state system and shift it to the Federal level, where there is even less accountability. We are specifically

troubled that this legislation would regulate agents from all states and for all lines of business who do business across a state line in what will inevitably be a new massive Washington bureaucracy. While IIABA does have problems with the current multi-state licensing system, we think that adding another layer of regulation on top of this is a big problem.

We believe that the states are better positioned to accommodate diversity and to respond to change. However, weaknesses exist in state regulation today. Unnecessary distinctions among the States and inconsistencies within the States thwart competition, reduce predictability and add unnecessary expenses to the cost of doing business. Similarly, outdated rules and practices do not serve the goals of regulation in today's financial services marketplace. Nevertheless and as noted previously, there is much that is good about the current state-based system that would be jettisoned through the creation of a Federal regulator, including an enforcement infrastructure upon which consumers throughout the Nation heavily rely to protect their interests. Federal charters and the establishment of a full-blown, unprecedented, untested and likely politicized regulatory structure at the Federal level are not the answer.

What is needed is a third way—a system that builds on, rather than dismantles, the States' inherent strengths to meet the challenges of a rapidly changing insurance environment. It must include mechanisms to promote the establishment of more uniform and consistent regulations and regulatory procedures, but must be poised to respond faster and more fully to the reality of electronic distribution and to emerging industry trends such as globalization and consolidation. It must modernize areas in which existing requirements or procedures are outdated, while continuing to impose effective regulatory oversight and necessary consumer protections. The result, for all stakeholders, should be a more efficient, modernized and *workable* system of insurance regulation.

For the last year, IIABA has been spearheading a cooperative attempt to develop just such a proposal. We have been working with other trade associations and directly with an array of national and regional insurers in an effort to identify precisely what must be fixed and how that might be done without displacing the components of the current system that work so well and without creating additional layers of government bureaucracy. Through this process, four specific areas for reform and the constraints on the mechanisms for that reform have been identified, and we have begun assembling a draft proposal for accomplishing these reforms. In my remaining testimony, I will outline the four components of this draft proposal.

a. Rate and Form Filing and Review/"Speed to Market" Reform

As previously discussed, the product regulation requirements in most States require insurers to file new rates and forms with the insurance commissioner and obtain formal regulatory approval before introducing them in the marketplace. Accordingly, an insurer that wishes to introduce a new product on a national basis may be forced to seek approval in up to 55 different jurisdictions. The process can be inefficient, paper intensive, time-consuming, arbitrary and inconsistent with the advance of technology and the regulatory reforms made in other industries. These cumbersome inefficiencies create unnecessary costs and delays, reduce industry responsiveness and drive many consumers into alternative market mechanisms. The regulatory regime in many States exceeds, in terms of scope and cost, what is necessary to protect the public.

In evaluating potential solutions to these problems, it is essential to recognize that uniformity is very difficult to achieve for property and casualty lines product regulation. Due to geography and other factors, some States must take into account issues that other States need not address. In addition, States may subject rates and forms to different levels of regulatory scrutiny, and personal lines and commercial lines products might also be treated differently.

Consumer protection concerns also limit the range of potential options to some extent. The concern is that the quicker and easier it is to have a new product or rate approved, the less protection consumers will receive. The solution thus must strike a balance between timely and quality reviews and appropriate consumer protections. In addition, "race to the bottom" and "turf" concerns have to be taken into account. Particularly under a scheme that employs a single point of review, States that use more stringent rate and form processes will be hesitant to accept the introduction of products or policies approved under more lenient guidelines. We believe it is possible, however, to strike an appropriate balance between realizing meaningful speed-to-market reform and protecting consumer interests.

Based on these objectives and considerations, the IIABA proposal is designed to do three things: (1) make the system more market-oriented; (2) make the system faster; and (3) create greater accountability. On the *form approval* side of the equa-

tion, this would be accomplished by preempting any state law that requires more than allowing all proposed forms (both commercial and personal lines) to be used no later than 30 days after they have been filed with the insurance commissioner unless the rate or form is disapproved within that time period. Under such a system, an insurer must at most file a proposed form with the insurance department 30 days in advance of the proposed effective date, and the form must be used at that time unless affirmatively disapproved by the regulator. If a department affirmatively approves the filing at any time within the 30-day period, the insurer may use the form immediately. Under the proposal, regulators would be entitled to a single 15-day extension of this disapproval period if an approval application is incomplete, and more permissive state filing/approval requirements would not be affected.

Under this approach, the current requirement that filings be done in every state in which the product will be offered would not be disrupted and current state form requirements would not be preempted (except as discussed below). In both the personal and commercial lines context, any disapproval must be articulated in writing and be based substantively on a properly promulgated statute, regulation or final court order. Many regulators have historically disapproved policy forms based on unpublished and unsubstantiated "desk drawer rules," but such actions would be impermissible under our approach. As noted previsously, more permissive form filing and approval requirements would not be displaced by the Federal rules.

Under our draft proposal, *rate approval* is treated much differently than form approval because the competitive market generally is the most efficient and effective regulator for rates. At the same time, in markets that are not sufficiently competitive, regulators need to retain the ability to monitor rates and to intervene to disapprove rates when necessary. Accordingly, under the draft proposal, any regulatory review requirement for rates in competitive markets that requires more than the filing of the rates with the insurance department would be preempted. States, however, will remain empowered to approve or disapprove rates in "non-competitive" markets if an affirmative finding has been made determining that the market is "non-competitive." That determination would be subject to Federal court scrutiny under the proposal.

b. Producer Licensing

Insurance agents and brokers must be licensed in every state in which they conduct business, and many producers face considerable hurdles in complying with inconsistent, duplicative and unnecessary licensing requirements when they operate on a multi-state basis. Although state licensing reforms adopted over the last two years offer great promise, additional improvements and refinements are necessary. The core proposal that we are developing to address this problem is to mandate licensing reciprocity in all states and thus achieve meaningful licensing reform that is national in scope. This could be accomplished by prohibiting a state in which an agent or broker is seeking to be licensed on a non-resident basis from imposing any licensure requirement on that person other than submission of proof of licensure in their home state and the requisite fee. Under a reciprocal licensing system that is national in scope, any individual agent or broker would only be confronted by a single set of licensing requirements.

The largest potential impediment to such a proposal is the concern by some that it could create incentives for certain States to establish lenient requirements with the hope that producers might flock there for resident licenses. Such a "race to the bottom" would be detrimental to the goal of fair, responsible regulation. To address the concern, the draft proposal would empower the NAIC to establish minimum standards for licensure. Only agents or brokers licensed as a resident in states that satisfy these minimum standards would be able to benefit from the preemption of state licensing authority over non-resident agents. If an agent or broker resides in a state that does not adopt the minimum-licensing standards, the proposal would explicitly enable that producer to apply to a state in which they do business and that has adopted such minimum standards to be licensed as a resident. Through this mechanism, Congress also could dictate minimum licensing standards. Under the draft proposal, for example, the minimum licensing standards would be required to include the performance of a criminal background check, utilization of standardized licensing cycles and application forms and fees in the filing process, imposition of a standardized trust account requirement for use in any state that requires maintenance of such accounts, and the mandatory availability of agency-level licenses.

c. Company Licensing/Transaction Review/Corporate Governance/Insolvency Standards/Financial Audits

Like insurance agents and brokers, insurers currently must be licensed by every state in which they do business. They also must satisfy a variety of corporate orga-

nization, solvency and governance requirements and go through multiple reviews of proposed corporate transactions (*i.e.,* change in control, mergers and acquisitions) and financial audits. Insurers need a single set of requirements; requisite compliance with the rules of multiple states creates delays and adds unnecessary costs without adding any tangible consumer benefit. Compliance with multiple audit procedures also is needlessly inefficient, costly and administratively cumbersome for insurers.

As in the insurance producer context, in developing potential solutions, the possibility of a race to the bottom and regulatory turf concerns of state insurance departments must be considered. In particular, state insurance departments likely will be hesitant to accept licensing, solvency and auditing determinations made by other States where the insurer does a significant amount of business in their States.

Regulation in this area also must contemplate the financial risks at stake if insurer solvency is not sufficiently regulated and companies become financially unsound. Concerns about possible strains on the guaranty system and the need for bailouts (such as in the savings-and loan-crisis) are never far from the surface when dealing with this area of regulation.

To remove duplicative and inconsistent requirements and examination procedures while at the same time maintaining sufficient protection for policyholders and the public, the proposal for companies tracks the producer licensing proposal by preempting the ability of all States to impose any licensing/transaction, review/corporate or governance/solvency standards or requirements on any non-resident company that is licensed by a state that is accredited by the NAIC. An insurer would be able to select as its "home state" either its state of domicile or its state of incorporation. States still would be free to require non-resident companies to be licensed but only upon proof of home-state licensure and the submission of a fee. The draft will clarify that any company that satisfies such Federal "passport" requirements can offer products in a non-resident state even if the state does not try to license them through the federally approved process (if the state does license in a federally permissible way, an insurer would have to comply with the state requirements, however). Hence, although any state could impose more stringent requirements on its resident companies, the system would remain uniform from the perspective of each individual insurer because each insurer would need to comply with only one set of substantive requirements.

To stem a potential "race to the bottom," a company will be required to be licensed in an "accredited" state in order to use its license as a passport to do business in other states and have the preemption outlined above apply to its activities in those non-resident states. The legislation would empower the NAIC to continue to conduct the accreditation process, subject to two new requirements.

First, additional accreditation requirements would have to be incorporated into the NAIC's accreditation requirements, including the new producer licensing minimum standards and any company minimum licensing, solvency or other standards that Congress chose to incorporate.

Second, the NAIC's accreditation criteria and any determination that a state is (or is not) accredited would be subject to review and disapproval either by a Federal agency or by a Federal court. Such oversight would be limited to reviewing NAIC determinations regarding what standards must be satisfied to become accredited and applications of those standards to states that have applied for accreditation.

To ensure that no company would be penalized (and thus unable to qualify for the "passport" rights) by virtue of the fact that it is domiciled in a non-accredited state, the legislation would permit an insurer to choose an alternative state of "residence" for licensing purposes if its state of domicile and its state of incorporation both are not accredited. Tentatively, the legislation will allow such an insurer to be licensed in the accredited state in which it does the most business based on premium volume. This should increase the pressure on all states to become accredited.

The legislation also must account for the possibility that the NAIC will refuse to implement the program and/or that the States will decide to boycott the process. In either event, the legislation will incorporate the back-up provisions included in NARAB. Hence, either if the NAIC refuses to implement the accreditation procedures as required under the Act or if a majority of States do not become accredited within a specified number of years, an independent body would be established either to stand in the shoes of the NAIC in conducting the accreditation process or—if States refuse to comply—to act as a licensing clearinghouse so that insurers will qualify for the licensing/solvency/etc. single set of requirements envisioned under the overarching approach. The proposal utilizes a combination of the NARAB back-up provisions and the Risk Retention Act non-resident state regulatory provisions to create these fall-back sets of provisions. The tighter they are designed, the less

likely it is that the NAIC and/or the States will refuse to comply with the intended NAIC accreditation procedures.

d. Market Conduct Examinations

Insurers are subject to examinations from insurance departments in multiple States. Exam procedures are inefficient and requirements are duplicative as a result of lack of coordination between States. Multiple exams are costly and administratively cumbersome for insurers. There often does not appear to be a sound justification for the examination and there are no restrictions on most insurance department's exercise of their market conduct examination power.

At the same time, however, it must be noted that market conduct directly involves consumer protection issues and, as a result, turf concerns and political concerns can be prevalent. Moreover, the focus of market conduct examinations is supposed to be on sales practices that occur where the customer is located rather than where the company resides, undermining the practicality of mandating a home-state regulation approach.

To reduce the administrative costs of compliance by clarifying the circumstances under which a regulator of a non-resident insurer may conduct examinations, the frequency with which such examinations may be conducted, and the review procedures that will apply, the proposal would require that, in the non-resident state, examinations may be conducted only to review compliance with properly promulgated statutory and regulatory requirements, and that no insurer can be deemed to have "failed" such an examination unless it is provided with an explanation in writing that sets forth the statutory and/or regulatory requirement that allegedly has been violated. The proposal includes a provision permitting any claim that a regulator is exceeding the scope of his or her authority to be brought in Federal court.

In an effort to facilitate greater coordination of market conduct examinations where appropriate, the proposal includes a provision authorizing and encouraging the use of multi-state compacts to facilitate market conduct examinations.

Conclusion

Although IIABA supports the preservation of state regulation of the business of insurance, we believe that reforms to the current system are necessary and essential. Specifically, IIABA believes the best alternative for addressing the current deficiencies in the state-based regulatory system is a pragmatic, middle-ground approach that utilizes Federal legislative tools to foster a more uniform system and to streamline the regulatory oversight process at the state level. By using Federal legislative action to overcome the structural impediments to reform at the state level, we can improve rather than replace the current state-based system and in the process promote a more efficient and effective regulatory framework.

Rather than employ a one-size-fits-all regulatory approach, a variety of legislative tools could be employed on an issue-by-issue basis to take into account the realities of today's marketplace and to achieve the same level of overall reform as the imposition of a Federal regulator. The specific ideas outlined above are just a few of the many specific solutions that could be adopted under this type of approach. Instead of relying on the agenda of a displaced and possibly politicized Federal regulator, however, insurance regulation would continue to be grounded on a more solid foundation—the century-and-one-half worth of skills and experience that the States have as regulators of the insurance industry. The advantage of this approach is that it offers the best of all worlds. It will promote the establishment of more uniform standards and streamlined procedures from state to state, protect consumers while enhancing marketplace responsiveness, and emphasize that the primary goals of insurance regulation can best be met by improving, not abandoning, the state-based system that has been in place for over 150 years.

The CHAIRMAN. Mr. Berrington?

STATEMENT OF CRAIG A. BERRINGTON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN INSURANCE ASSOCIATION (AIA)

Mr. BERRINGTON. Thank you very much, Mr. Chairman.

My name is Craig Berrington. I'm general counsel of the American Insurance Association. AIA represents insurers doing business in every state, writing all types of property and casualty insurance.

Two years ago, the AIA board, which has insurers of various sizes, small to large, formally decided to support optional Federal chartering, while at the same time continuing to support efforts to reform state insurance regulation. Our members were there at the creation of the state system and have worked diligently to reform it. They have concluded, however, that while some states—that in some states, sufficient—I'm sorry—they have concluded, however, that while useful reforms have occurred in some states, sufficient nationwide reform through individual state actions is unlikely under the current state-centric approach. Therefore, nationwide reform from the Federal level is critical.

I'd like to take a few minutes this morning to provide the Committee with some insurance background and to sketch out our optional Federal chartering and proposal from a property and casualty insurance perspective.

We generally think about insurance as individual transactions, and there has been discussion about that this morning—homeowners, auto, business, workers' compensation, life—but the broader truth about insurance is that you cannot have a democratic free-market society without it. Democracy and free markets are all about taking risks, and insurance is all about making those risks manageable in our personal and in our entrepreneurial lives.

Insurance is also a critical early warning system for society. However, as with other messengers throughout the ages, insurers often get blamed for the messages that they bring and the truths that those messages tell. But those truths are the beginning of coming to grips with a problem and then solving it.

Like banking and securities, insurance is integral to the financial services lifeblood of the country, yet its regulated very differently. This results in a real dichotomy, a business that is so integral to the national interest is controlled so overwhelmingly by the most local of regulation.

How insurance should be regulated and by what level of government is an old argument in the United States. We have new legislation addressing these issues, but this is not a new debate. It goes back at least to 1869, as was pointed out earlier, where the Supreme Court held that insurance was intrinsically local and Congress could not constitutionally regulate it. That, of course, was overturned in 1944 and followed by the McCarran Act in 1945.

So insurers now operate in an environment with 51 different state regulatory systems, with 51 different regulatory philosophies, with all the obvious costs, complexities, and confusion that this causes. In these 51 states, there are approximately 350 different regulatory price-control schemes for property and casualty insurance, and over 200 different regulatory approaches to approving the introduction of new P&C products. This cannot be efficient.

Playing out within the argument about where insurance should be regulated is the argument about how it should be regulated. As the state system developed, it began to rely upon, as its two primary regulatory tools, the imposition of government price controls and a presumption against product innovation. In choosing this course of regulatory behavior, most states wound up enshrining in their laws and regulations governmental command-and-control economic theories that have been discredited at home and around the

world over the past 50 years. They adopted a system that distorts regulatory goals by putting almost all the regulatory eggs in the price and product-control basket. By doing so, they created a system that discourages innovation and maximum competitive opportunities, that denies consumers maximum choice, and that often makes the pricing of insurance a political act.

I should say that the benefits asserted for Prop 103 are benefits that I disagree with and we might want to discuss later.

But what kind of change do we want? In short, we want insurers to have the option of obtaining a Federal charter. In the broadest conceptual sense, the bill would allow insurers to choose between state regulation and the Federal charter with a single Federal regulator. The bill would focus Federal regulation on financial integrity, market conduct, and consumer protection, not on government price controls and an ingrained hostility to the development of new products. The bill would normalize the antitrust legal environmental for federally chartered insurers at the same time as it normalizes their right to price their products in the marketplace. We are willing to give up the McCarran antitrust protection with regard to price if we can be free to price our products in the market, just like any other business. We think that's a fair tradeoff.

The bill would allow the states to continue to set the mandatory standards of their insurance coverage laws, like, say, automobile insurance and workers' compensation rules. And federally-chartered insurers would have to follow those mandates when they did business in the state.

The bill would generally preempt other state insurance laws for federally chartered insurers, but keep them subject to state contract and tort law, as well as the state premium tax regulation, state residual markets, and state guarantee funds.

And, finally, it would let any insurer that thought that the state system worked better for it to stay in the states. We know, Mr. Chairman, that not everyone in the insurance industry favors our optional Federal chartering approach. Although support for it continues to grow, we know there are a wide variety of views in the industry. Many insurers, especially, I'm told, some smaller one, favor continuation of the current state system, and they should be allowed to continue in it if they would like to.

We also understand, Mr. Chairman, that in the debate over change the burden is on us who favor change. But we, the advocates of change, are not the only ones who have a burden to meet. Those who advocate the status quo have the burden of moving beyond rhetoric to reform, and really showing us that reform can be done at the state level.

We believe that the Federal legislation incorporating our reform principles is needed to move forward now and to continue to work on state reform where we can.

I'd be happy to take any questions later in this session.

Thank you very much.

[The prepared statement of Mr. Berrington follows:]

PREPARED STATEMENT OF CRAIG A. BERRINGTON, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN INSURANCE ASSOCIATION (AIA)

Thank you, Mr. Chairman. My name is Craig A. Berrington, and I am Senior Vice President and General Counsel of the American Insurance Association ("AIA"). I appreciate the opportunity to testify here today on the important issue of insurance regulatory reform. Attached to my written statement is an article that appeared in the August 2003 edition of Best's Review, which further details AIA's position in favor of an optional Federal charter.

AIA is a national trade association representing more than 424 property and casualty insurers that write insurance in every jurisdiction in the United States, with U.S. premiums exceeding $103 billion in 2001. AIA member companies offer all types of property and casualty insurance including personal and commercial automobile insurance, commercial property and liability coverage, workers' compensation, homeowners' insurance, medical malpractice coverage, and product liability insurance.

For AIA members, insurance regulatory reform is, and will continue to be, a key concern. The ability of insurers to bring products to market in a timely and cost-effective manner free from government price controls, along with uniform regulatory treatment regardless of where they are domiciled and where they do business, is critical. Real reforms are necessary if insurance is to remain a competitive, vibrant industry.

The state insurance regulatory system for property and casualty insurance is premised on government price controls and on the imposition of barriers to bringing new products to market. This system is replicated 51 times, often in different and inconsistent ways. Even within each jurisdiction, there are often differing systems for different lines of business, making the process incredibly cumbersome, inefficient, and ultimately unresponsive to consumer needs. A limited survey of state requirements finds approximately 350 dictating how rates are to be filed and reviewed and approximately 200 relating to the filing and review of new products. We need a more efficient regulatory system than this.

Recognizing that the long-term best interests of policyholders, insurers, and the overall economy are served by an efficient, effective regulatory system, AIA examined the "value chain" associated with the regulation of insurance companies and products and identified opportunities—based on both domestic and international regulatory models—to remove current regulatory impediments to competition, thus creating greater value for all stakeholders. From that discussion and analysis of the current regulatory system, several themes emerged.

First, an entrenched state focus on government price and product controls discourages product innovation and competition, ultimately denying consumers choice. The current regulatory system concentrates on the wrong things. While repressing prices may be politically popular, it is ultimately economically unwise as it masks problems and over a period of time can lead to a crisis, forcing sizable subsidized residual markets and market withdrawals that exacerbate the problem.

Any system that requires companies to "beg the government" in order to use their product and to establish a price improperly places the government in the middle of marketplace decisions. In contrast, a system that relies on marketplace competition and that makes the consuming public the central player in the system is well-focused.

Second, there is inconsistency among state statutory and legal requirements and the administration of state systems. The need to meet differing regulatory demands in each jurisdiction increases compliance costs, discourages innovation, and makes it difficult for insurers to service customers doing business in more than one state.

The current regulatory system is a jumble of individual state requirements. State insurance codes provide hundreds of different rate and form regulatory requirements for the various lines of insurance. Uncodified practices of many state insurance departments, known as "desk drawer rules," impose additional, often needlessly onerous, procedural requirements. One problem that this causes in the marketplace is that companies wishing to launch a national product cannot do so until both the price and product have been separately approved in every state.

Third, in many states, regulatory rate and form approval delays are chronic and increasing. Federally-regulated financial services industries have no similar regulatory obstacles to getting rates and products to market quickly. The emphasis on such controls in insurance slows products from entering the market and inhibits product creativity.

Our industry stands out as one of the most heavily regulated sectors of the U.S. economy. But, it is not just a question of regulation. It's the fact of misguided regulation. If the insurance industry cannot keep pace and cannot provide consumers

with real choices, the economy suffers. Insurance provides much-needed security for businesses and individuals to innovate, invest and take on risk. Yet the ability to innovate, invest and take on risk is substantially impeded because insurers labor under the weight of a "government-first, market-second" regulatory system. This system rewards inefficient market behavior, subsidizes high risks and masks underlying problems that lead to rising insurance costs. The bottom line is that consumers ultimately will pay more for less adequate risk protection than would be the case under a more dynamic, market-oriented regulatory system.

Debate and Solutions: Optional Federal Charter Proposal and Other Ideas

There are a variety of views within the industry about the most appropriate solutions to this regulatory dilemma. Almost all those involved in the debate recognize that, on the whole, the current state system is under great stress. There is, in addition, we believe, a growing consensus—although certainly not unanimity—that the state system is not just stressed, it is broken. The only question remaining is how best to solve the problem; there are a variety of ideas.

For AIA and a number of others, the solution is a new regulatory paradigm that eliminates government obstacles to getting prices and products to market, and thereby providing consumers with choice. Members of AIA were there at the creation of the state system. They have much invested in this system, which they know well. They have been at the forefront of efforts to reform the system and they approve of substantive reform efforts of individual state insurance commissioners and of the National Association of Insurance Commissioners ("NAIC"). However, recognizing systemic barriers to efficiency and competition, AIA's Board of Directors decided more than 2 years ago that the kinds of reforms necessary to keep the industry vital and to maximize consumer benefits were unlikely to be achieved in a state regulatory environment. Thus, the AIA Board voted to support the enactment of optional Federal chartering legislation, which would allow insurers to obtain a Federal charter, but not to displace the state system for those who want it.

One of the benefits of our optional Federal charter proposal is that it accommodates those who believe their business is best served by local regulation. Other benefits will follow, including consumer choice, healthy competition and the ability of regulators to focus a national system on meeting core financial tests and on protecting consumer interests.

AIA is not alone in advocating an optional Federal charter solution. After our Board determined to advocate for this system, we were joined by the American Council of Life Insurers and the American Bankers Insurance Association. Further, non-AIA member insurers are looking increasingly at Federal solutions as well.

Support for the Optional Federal Charter Solution

AIA believes that optional Federal chartering will benefit consumers and boost the competitiveness of the insurance industry. Our proposal is designed to provide options for consumers, to achieve systemic efficiency, and to normalize regulation of insurers. While some aspects of the insurance industry are local in nature, the business is increasingly national and international in its customer focus and regulatory needs. The insurance industry is extremely diverse. A state-based regulatory approach may be appropriate for companies that operate on a single-state or regional basis, but, for national and international companies—as well as their customers—the current fifty-one-jurisdiction regulatory system is costly and inflexible. Reforms such as optional Federal chartering would allow companies and customers to choose the regulatory approach that is most suitable for their size and scope of operations.

Principles for Optional Federal Chartering

Keeping this context in mind, our proposal focuses on financial integrity, not government rate and form regulation. The proposal creates a Federal regulatory system in the Department of the Treasury to grant Federal charters to qualified insurers and reinsurers—and to their agents—for the purpose of regulating their conduct. The proposal is designed to regulate federally chartered insurers, not to create or regulate state reparations laws, like the mandatory requirements of state automobile or workers' compensation insurance laws. That authority over state reparations laws would remain within the state legislatures. The proposal otherwise preempts most state insurance regulatory laws for those insurers that obtain a Federal charter.

The proposal substantially normalizes the Federal antitrust environment for federally chartered insurers, and allows any insurer, reinsurer, or insurance producer that wants to stay in the state regulatory system to do so without any obligation to the Federal system whatsoever. In sum, the optional Federal charter proposal fosters freedom of choice for insurers and their customers.

More specifically, in terms of scope, the proposal would apply to all lines of property and casualty and life insurance. Insurers and holding companies would have essentially unrestricted options with regard to use of the Federal chartering system. For example, a holding company could decide to have all of its insurance affiliates federally chartered, just some, or none. For mergers and acquisitions, states would have a role only if one or more of the insurers were state-licensed.

The Federal regulatory system would be organized around a new Treasury Department agency. The commissioner of the new agency would serve a five-year term, and would be appointed by the President with the advice and consent of the Senate. The new Federal agency would be funded by the federally chartered insurers, not by the public. It would have no rate regulation authority, but would have access to policy forms, which federally chartered insurers would be required to make available for inspection. Chartered insurers would also be required to file an annual list of their standard policy forms with the Federal agency.

The role of the new Federal office would be to make concrete and to enforce the statutory standards for obtaining and retaining a Federal charter through regulation. The office would also have full financial and market conduct regulatory and examination authority, including the authority to establish prohibitions on unfair trade and claims practices. An insurer could lose its Federal charter for any knowing significant violation, and could also be fined or required to pay restitution. Except for non-preempted areas such as mandatory state residual market participation, a state insurance regulator could not bring a regulatory action against a federally chartered insurer, but could file a complaint with the Federal agency. The proposal also includes a rehabilitation and liquidation process, incorporating the NAIC model, and authorizes insurers to establish self-regulatory organizations subject to Federal oversight.

In terms of the interplay between Federal and state law, there are three critical areas—state law preemption, antitrust, and state tort and contract law—affected by the proposal. First, all state insurance laws and regulations would be preempted by the proposal unless specifically preserved. Examples of preempted areas of regulation include licenses; solvency and financial condition; mergers and acquisitions; rates and forms; marketing; underwriting; claims; so-called "take-all-comers" laws; and policy non-renewal or cancellation limitations. Major areas of state regulation that are expressly not preempted by the proposal include mandatory residual markets; premium tax laws; state guaranty funds; general corporate governance laws; mandatory coverage provisions of state reparations laws; workers' compensation administrative mechanisms; and mandatory statistical or advisory organizations. Even for areas of state regulation that remain in effect, states cannot use those to discriminate against federally chartered insurers or their affiliates. The new Federal agency can block any state laws that it finds discriminatory. In addition, it can block any other state law that is inconsistent with the optional Federal chartering proposal.

Second, with regard to the antitrust interplay, the proposal substantially normalizes the application of the antitrust laws to federally chartered insurers as the *quid pro quo* for a marketplace-oriented regulatory system. As a result, there is generally no McCarran-Ferguson Act protection from the Federal antitrust laws, except for state-mandated activities. In practical terms, this means that collective ratemaking activities are subject to antitrust scrutiny, but that specific antitrust protection remains for policy forms development as the tradeoff for regulatory authority.

Third, with respect to state tort and contract law, federally chartered insurers are still subject to state court tort and contract suits, as well as to state "bad faith" insurance regulation laws.

NAIC Role and Limitations in Regulatory Modernization

AIA has been actively engaged in advancing the elimination of government rate and form controls on a state-by-state basis for a number of years. AIA applauds the spirit of NAIC efforts and we will continue to work with the NAIC to produce needed regulatory reform in the states. AIA, as well as some other trades and insurers, fully supports continued efforts to modernize and improve the state regulatory system. But, we urge Congress to move forward with the creation of an optional Federal charter because ultimately it is impossible for the NAIC to deliver uniformity or complete systemic reforms at the state level.

Efforts at regulatory uniformity have consistently failed, because many states have refused to sign on to a united effort and there is no guarantee that any uniform standards would actually import the correct standard. What is left, at best, is a dysfunctional uniformity, such as:

- *Privacy:* In response to the Gramm-Leach-Bliley Act's ("GLBA") privacy standards, the NAIC unanimously adopted its model "Privacy of Consumer Financial

and Health Information Regulation" in September 2000. While AIA supported the adoption of that model, there has been little uniformity even where states purportedly base privacy laws and regulations on the model. States have enacted and promulgated privacy laws and regulations that depart in numerous ways from both GLBA and the NAIC model. This created a costly patchwork of privacy obligations. Compounding the problem is a 20-year old NAIC insurance privacy model that remains the law in sixteen states and differs in scope and form from the more recent model.

- *Producer Licensing:* A year ago, the NAIC was supposed to certify that it had met the conditions of GLBA's registered agent and broker provisions. Despite certification, key states are still not in compliance. Even those that have been certified by the NAIC still allow variances—extra requirements like fingerprint and background checks—before a non-resident license is granted.
- *Interstate Compact Attempts:* The NAIC has created model interstate compacts, though only for life insurance and not for property and casualty insurance. Since then, one state adopted a version different from the NAIC model, two large states publicly opposed the model, and three other large states began working on their own model.

More than three years ago, the NAIC unveiled a "new" modernization effort designed to improve state insurance regulation, in its "Statement of Intent." It declared that state insurance regulators must modernize insurance regulation to meet the realities of an increasingly dynamic, and internationally competitive, insurance marketplace. Even then, such pronouncements were not new—state insurance commissioners have been talking about uniform efforts since 1871.

Last month, the NAIC issued a renewed commitment to its "Regulatory Modernization Action Plan." This plan abandons previous efforts for substantive changes in the regulatory framework. For the most part, the NAIC plan focuses on incremental efficiencies that make no major systemic changes in today's outmoded regulatory framework. The plan does not even reinforce the NAIC's own "Speed to Market" recommendations that the NAIC adopted in 2000.

Consumers would benefit from a free market, without today's antiquated product and price controls. But the NAIC's latest plan not only fails to eliminate this discredited system, it retreats from previous and stronger recommendations in this area. To stimulate healthy regulatory competition in insurance, we must turn to a market-oriented environment. The NAIC has proven that it cannot force states to let such an environment flourish, so other, more effective avenues must be pursued.

Conclusion

AIA advocates a market-based approach to insurance regulation that does not rely on government review of prices or products, but permits competitive forces to respond to consumer demand. The state of the current regulatory environment makes comprehensive insurance regulatory reform imperative.

There have been decades of NAIC reports and commissioner promises of reform, none of which has ever produced the system-wide reform that is needed. The failure to enact systemic reform is not for lack of effort, but is a product of 51 different jurisdictions with 51 different regulatory and political philosophies. Reform must occur at the Federal level, and we ask that you consider the optional Federal charter as the appropriate vehicle.

I appreciate the Committee's attention and the opportunity to speak today on this important issue. Thank you.

ATTACHMENT

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Photo illustration by Karen McNamara

Opportunity for Option

OPINION: Insurers and consumers would benefit from an optional federal regulatory system that encourages market competition.

by Craig Berrington

Insurance is an integral part of the financial-services lifeblood of the United States; banking and the securities industry comprise the other major sectors. Banking and securities have a coherent national pattern of regulation. Insurance does not. Insurance is regulated very differently from the other two aspects of the financial-services industry. Our industry, which underpins the entire economy, and which must be flexible and market-sensitive, is still largely controlled by failed regulatory paradigms left over from the early 20th century.

It is not difficult to come up with issues which overwhelm the state-based system of insurance regulation. Consider the successful effort to develop a mechanism allocating risk for terrorism between the private and public sectors that arose out of the Sept. 11, 2001, attacks. This effort rightfully was undertaken at the federal level. It took about 15 months to complete. Now, the Terrorism Risk Insurance Act provides much-needed economic security against further terrorist attacks.

Today, property/casualty insurance is being called upon to address increasingly complex societal needs. The current regulatory regime, with its lack of flexibility and national reach, cannot rise to this challenge. Given its failure, a national dialogue about the need for some kind of federal option for insurers—one that could operate simultaneously with the state system, analogous in some ways to the current dual banking system—is developing. Playing out within the discussion about where insurance should be regulated is the argument about how it should be regulated. For example, should regulation continue to focus so heavily on price and product controls? Should the regulator be able to dictate the kind of product creativity that an insurer will use to bring products to the market? Unfortunately, these are not purely rhetorical questions. Such broad, intrusive government controls currently lie at the very heart of the business of insurance. The American Insurance Association believes this is exactly the wrong approach to regulating a healthy, vibrant, competitive insurance marketplace.

The Need for a Paradigm Shift

The industry, its state regulators, and the National Association of Insurance Commissioners have been trying to come to grips with these issues for

Craig Berrington is senior vice president and general counsel of the American Insurance Association.

many years. But the hard rock of reality is that while they have been struggling with these problems, little tangible progress has been made. And, because the public policy decisions defining the regulatory system have been wrong—wrong from the standpoint of modern economics, wrong from the standpoint of business and consumer needs—we have quite by accident hit the regulatory trifecta. We have a system for property and casualty insurance regulation that is archaic and dysfunctional, and which corrupts the process of pricing and creating insurance products.

The current system enshrines economic theories that have been discredited at home and around the world over the past 50 years. It distorts regulatory emphasis by putting almost all the regulatory eggs in the price and product control basket. It distorts the marketplace because it discourages innovation and maximum competitive opportunities. It denies consumers maximum choice. All too often, it politicizes the pricing of insurance, which ends up shortchanging consumers and citizens in two basic ways. First, the current system destroys a primary societal function of insurance—providing an actuarial link between risky behavior and cost. In addition, insurance availability is reduced as companies unable to make a profit because of artificially low prices are driven out of heavily regulated states and lines of business.

It is no exaggeration to say that, in the current system, insurance companies essentially have to go to the state and beg for a reasonable price at which to sell their products, or beg to get a new product introduced into the marketplace. When that is how business and government interact with each other, it is inherently a corruption of both the business and the government enterprises—not corrupt individuals, but a corruption of the underlying

Optional Federal Charter, State Regs or Something Else

The American Insurance Association, American Council of Life Insurers and the American Bankers Association Insurance Association have collaborated on a legislative proposal for an optional federal charter, which also makes provisions for including health insurance in the future.

Conceptually, their idea focuses on financial integrity and market conduct—not rate and form regulation. It would create the Federal Insurance Chartering Office, a new agency in the Treasury Department. The director would serve a six-year term, would be appointed by the president and would look to the U.S. Senate for advice and consent.

While this federal regulator wouldn't regulate prices or rates, insurers would have to make forms available for inspection. The federal regulator would grant federal charters to qualified insurers and reinsurers and their agents.

Under the AIA-ACLI-ABAIA proposal, any insurer, reinsurer, agent or broker wanting to stay in the state system could do so without obligation to the federal system.

States would keep authority over insurance reparation laws, such as state automobile and workers' compensation laws. Otherwise, most state insurance regulation would be pre-empted for those choosing a federal charter.

Once a holding company put any of its businesses in a federally chartered insurer, the sole regulator of the holding company would be the federal regulator. For mergers and acquisitions, state regulators would have a role only if one or more of the insurers were state-licensed, under the AIA-ACLI-ABAIA proposal.

The Independent Insurance Agents & Brokers of America has a proposal which calls for Congress to create federal insurance standards that would be enforced by state regulators. IIABA opposes an optional federal charter but wants improvements in state regulation. It sees this concept as a middle ground, and the most politically plausible legislation that could get through Congress.

The IIABA scenario would use Congress to pre-empt some aspects of state regulation and set minimum standards—a proposal the agents say would fix about 90% of what's wrong with state regulation. Property/casualty and life insurers both would benefit, and the IIABA has said some 20 large and mid-sized insurers—some well-known names—have been involved in crafting the proposal. The proposal is still in draft form and not yet ready to be presented as a bill, but it's been shown to members of the House Financial Services Committee and to insurance trade associations.

The plan goes beyond direct concerns of agents, such as licensing, and encompasses areas that affect insurance companies, such as policy form and rate regulation, company licensing and state accreditation, and market-conduct examinations, according to a copy of the proposal. IIABA's concept doesn't call for Congress to threaten the states if they don't take actions by a certain date; it is pre-emption right off the bat.

On rates and forms, for example, the IIABA proposal would give states 30 days to approve or disapprove. If no action is taken, the rate or form would be deemed approved. It could solve the speed-to-market concerns of companies that say it can take a year or two to get product approvals from different state insurance departments.

As for agent licensing, an agent in good standing in one state should be able to sell insurance products in another, IIABA contends. Agents still would pay the state fee under IIABA's proposal, but the state where the agent lives would regulate the agent and do the background check.

—Dennis Kelly

and legitimate purposes of business and government. We can—and must—do better than that. In response to the failures in the state regulatory system, we and other advocates of regulatory modernization have developed federal legislation to provide an alternative for insurers that seek one. It would present a very different way of going about insurance regulation.

Every honest observer of the insurance regulatory system agrees that the current state system is failing. So the question that can no longer be ignored is this: how are these problems going to be repaired? The NAIC and many states have pursued reform efforts in an attempt to remedy the situation. They have been working to create uniform regulatory standards among the states to ameliorate the current patchwork of laws and regulations with which insurers must comply. There is some benefit to uniformity, but only if the standards themselves are market-oriented. Moreover, to the extent that the emerging standards really incorporate the same old command-and-control regulatory system where price is controlled and where product creativity is discouraged, uniformity only makes things worse; it does not fix the fundamental flaws of the state-based system.

We have worked with, continue to work with, and respect the NAIC and individual commissioners who are doing the best they can. But the talk of reform at the NAIC has been going on for a long time; results are episodic at best and vary dramatically from one state to another. Many reasonable people have concluded that the only way to achieve real reform is to provide another regulatory option.

Envisioning a Federal Option

Our proposal is a consumer-oriented approach. We think that market competition is the best regulator of price and the best way to attract new entrants into the marketplace. Both competitive pricing and a wide variety of readily available products and services directly benefit the insurance consumer. Moreover, it is critical that each insurance product meet every legal requirement in a particular market. Our proposal absolutely obligates insurers to do just that. What it does not do, however, is place roadblocks in the path of legal and creative products getting to market. The essence of our proposal, then, is market-oriented regulation.

Opponents of optional federal chartering often cite political and substantive concerns, such as state reluctance to give up tax revenue, effective functioning of state guaranty funds and the need for local market prerogatives. None of these challenges presents an insurmountable obstacle to the creation of a workable, optional federal charter as we envision it.

Premium Taxes. It should be made clear that there is absolutely no desire on the part of optional-federal-charter advocates to change state authority to collect and to levy premium taxes. When federal legislation passes, it will assuredly retain state premium-tax authority because there is no interest in doing anything to the contrary, and there is no constituency seeking anything to the contrary. That was one of the bases for the McCarran-Ferguson Act in the first place.

State Guaranty Funds. The current optional-federal-charter proposal does not do away with, attack or undermine state guaranty funds. State guaranty funds would remain intact; indeed, federally chartered insurers would be required to participate to the extent that states want to allow them to participate. Stability in the guaranty-fund environment is highly desirable, especially since the state guaranty system is now under the greatest stress it has faced in more than 30 years. In some ways, optional federal chartering could actually strengthen the state-based system. Federal guaranty standards would likely be as rigorous as the best state standards and induce movement toward both high and uniform standards.

Market Conduct. An effective regulatory system (whether state or federally based) focuses on financial integrity through a tough—and smart—market-conduct examination process, empowering professionals involved in the financial or regulation side who are skilled and know what they are doing to get at the bad actors and take care of them quickly. In this connection, there is no doubt that a unified federal system can spot troublesome—or dangerous—trends much more quickly than 51 separate state efforts.

Addressing Local Needs. One of the objections sometimes raised to optional federal chartering is that insurance, unlike banking, securities or many other types of economic goods, is local in nature and therefore can only be regulated at the state level. While many economists would be puzzled by the characterization of insurance as inherently more local than other types of economic goods, it should be underscored that federal regulators are very effective at administering programs that connect down to the local level. Indeed, historically, the more critical the issue, the more likely that the resolution of that issue has been entrusted to federal authority. Do Americans believe that their assets held at federally chartered banks are less well protected than those held at state chartered banks? Would investors feel more confident in having the Securities and Exchange Commission replaced by 51 separate state securities regulators? The obvious answer to both these questions is "no," even though the states also have banking and securities agencies. The federal government also manages a nationwide program to make sure that workers get minimum wages and overtime protection. Now, after the passage of many years, Americans entrust the safety of our nation's workforce to a federal regulatory system because, in fact, the states were really not able to do it. Will every kind of federal system be perfect? Of course not. But the fact is that the nation has entrusted to a federal system the obligation to administer programs that must—and do—respond directly to the needs of citizens on the local level. And insurance would be no different.

Another question often raised about a potential federal regulator is, would insurers face a much more highly politicized and anti-market insurance environment at the federal

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level? It should be noted that the federal approach to price and product controls going back to the mid-1970s, when price controls were the norm in regulation, has led to having them removed for many industries, such as airlines and banks. Indeed, in the case of airlines, federal price deregulation has effectively democratized air travel in the United States.

We already have some recent experience in dealing with insurance regulation at the federal level in the Terrorism Risk Insurance Act. While not perfect, TRIA meets a very basic national insurance need. Also, the Treasury Department has been a model regulator in carrying out the TRIA statute. If experience is a guide to future behavior, we should be cautiously optimistic about a regulatory system that is managed by the United States Department of the Treasury. They have done an excellent job with implementing this law. They have been businesslike. They have preserved and assured the interests of the U.S. government without being needlessly aggressive. They have not taken positions that unnecessarily make it burdensome and difficult to do business. They have taken practical problems that we have brought to them and have proffered up practical solutions. Moreover, Treasury started out with very little experience and knowledge with regard to insurance, but they built their information and knowledge base dramatically. Anyone who claims that a federal regulatory operation system cannot work should take note of this experience.

The Importance of Having Options

The need for a new model of insurance regulation is long overdue. The costs inherent in the current system are growing daily for the industry and consumers. Despite this fact, there is still reluctance by some in the insurance community to have an optional federal regulatory system alongside the state-based one. Fortunately, any risks that arise out of development of an optional federal system are mitigated precisely by the fact that it is optional. The state-based system will remain in place. Even for the risk averse, pursuing optional federal chartering is a net positive, especially when considering the enormous costs of continuing the status quo.

We believe that the effort to put an optional federal-chartering system in place ultimately will bear fruit. Such a system can both improve insurance regulation and enable the insurance market to successfully meet the challenges facing it today, and that it will face for years to come. There is every reason to advocate such a system—to push ourselves and our regulators to a regulatory paradigm that is truly efficient and effective. There is simply no excuse to accept the broken system we have today; that would mean accepting a regulatory system that is designed to undercut the marketplace on a daily basis to the detriment of all concerned. Insurers and all of our commercial and personal lines customers deserve better.

STATEMENT OF HON. JOHN E. SUNUNU, U.S. SENATOR FROM NEW HAMPSHIRE

Senator SUNUNU [presiding]. Thank you, Mr. Berrington.

Mr. Heller?

STATEMENT OF DOUGLAS HELLER, THE FOUNDATION FOR TAXPAYER AND CONSUMER RIGHTS

Mr. HELLER. Thank you, Mr. Chairman and Senators.

I'm Douglas Heller, with The Foundation for Taxpayer and Consumer Rights.

As Senator Hollings started today and pointed out, that there is a strong regulatory regime in this Nation that protects consumers

and equally ensures a stable insurance market. That system is California's Proposition 103, a voter initiative that was passed in 1988. And, indeed, most of its provisions are contained in Senator Hollings' admirable insurance consumer protection bill, and for that we are appreciative.

In the main, Proposition 103 creates a prior-approval system of insurance. It requires insurance companies to justify their rates, it allows the insurance commissioner to approve or deny or amend and alter insurance rates as they come. It also provides the right of the public to inspect the books of insurance companies and to challenge those rates in case the insurance companies are asking too much or the Commissioner is looking for too little.

In recent weeks—excuse me, in recent months—our organization has challenged two such rate increases proposed by medical malpractice insurance providers in California. And as a result of our challenges, we have saved doctors $35 million, protecting them from excessive price hikes. We also saved $26 million for insurance policyholders for the fourth-largest homeowners company when we blocked a rate increase just last month using Proposition 103.

Proposition 103 also ended the antitrust exemption for California carriers that we know exists throughout the rest of the Nation. And, as Senator Hollings indicated, Proposition 103 did require rates to go back to adjust for historic gouging. And, as a result, there were $1.2 billion in rebates paid to California consumers.

It's been a quantitative success. Auto liability rates are down 22 percent since Proposition 103 passed in California. They're up 30 percent nationwide.

But also, and this is very important to note, the insurance industry in California has been more profitable than it has been in the Nation as a whole. Over the last 10 years, average profits in auto, homeowners, farm-owners insurance, medical malpractice insurance, has been higher in California than the national average.

And, of course, it's been a qualitative success, because we've had a stable market, without the ups and down swings that we've seen throughout much of the country.

But despite the success, we hear time and again the insurance wants to deregulate, or when they talk about Federal regulation or Federal options, it's just a way to get around the more stringent approaches around—in certain states, like California.

But the reason they don't want regulation is not because it hasn't been a success, but because it tends to air their dirty laundry, things like the economic cycles that impact the insurance market. Insurance companies, as we know, make a lot of their money through their investment practices. And, as a result, they follow the economic cycles of the Nation. And when interest rates fall, their investment income declines. When the stock market falls and they lose money, they need to—they want to raise more money.

And this, we've seen in a recent study we did of ten major insurance companies. The insurance industry is putting more and more of their money into higher-risk investments in the corporate sector in equity, stock investments, as well as corporate bonds. And, as a result, these ten companies that we studied lost a quarter of a billion dollars in investments in just those five corporate frauds that this Committee and other Senate Committees studied in re-

cent years, Enron and WorldCom being the main protagonists of those losses.

So when the insurance companies lose their money, they then have to come up with an excuse, and instead of taking responsibility for their investment mistakes, the industry points to consumers and say, "Oh, the claims have gone up." Well, we went back, and we studied 15 years of medical malpractice claims loss history, and we see that the insurance company, when they project losses initially, are inflating that data. Thirty percent higher. When we look, after 10 years of accounting revisions by the insurance industry, when they said, "We had $10 billion in losses this year," 10 years later they've revised those numbers down to $7 billion. They inflate that data, those loss data, so they can push for rate increases so they can tighten up coverage of insurance, and, of course, so they can push for changes in tort laws.

That's the third dirty secret of the insurance industry. These changes in tort laws actually don't fulfill the promises of rate decreases.

I can go through, and perhaps, if you're interested later on, I could talk about some of the studies we've done to show that these tort law changes haven't worked. But I think the best way to explain it is to just read to you what the insurance industry has said when under the scrutiny of regulation. They have been asked about the impact. When we challenged the rate increase of SCPIE indemnity, the second largest medical malpractice provider in California, this is what their assistant vice president and actuary said to the regulator, "While MICRA"—which is California's malpractice caps law—"was the legislature's attempt at remedying the malpractice crisis in California in 1975, it did not substantially reduce the relative risk of medical malpractice insurance in California." "Caps do not work," is what the insurance company told the regulator, because they—because the company wanted to raise rates instead.

And when, in 1987, the Florida regulators asked St. Paul and Aetna and other companies to explain what was happening in the wake of their tort law changes, St. Paul said that the conclusion of their study about their caps, "will produce little or no savings to the tort system as it pertains to medical malpractice."

Senators, insurance reform is a crucial element of improving our economy, because, as Chairman McCain had said earlier, insurance is absolutely integral to the economic lives and well-being of American consumers and businesses. I doubt there's any disagreement on that. The question is, How do we do it? Do we do it with regulation, or do we concede to a market and to tort law changes and such that have, in the past, not produced a savings that we expect and that consumers need?

I appreciate the time to participate in this hearing and will be happy to take any questions.

[The prepared statement of Mr. Heller follows:]

PREPARED STATEMENT OF DOUGLAS HELLER, FOUNDATION FOR TAXPAYER AND CONSUMER RIGHTS

"PROPOSITION 103: A MODEL FOR INSURANCE REGULATION"

Mr. Chairman and Members of the Committee:

Thank you for inviting the Foundation for Taxpayer and Consumer Rights (FTCR) to present its views on insurance regulation and engage in this important discussion on the state of insurance regulation and proposals to improve it.

FTCR is a nonpartisan, nonprofit organization that conducts research, education and advocacy activities on insurance matters and other consumer issues, including healthcare and energy. In particular, FTCR has done extensive work on issues related to auto, home and medical malpractice insurance and has long been an advocate of insurance industry regulation. FTCR's founder, Harvey Rosenfield, is the author of Proposition 103, the California insurance reform initiative that provides the state with the Nation's most stringent system of insurance regulation. I am FTCR's senior consumer advocate and insurance specialist.

We would like to thank Chairman McCain for holding this oversight hearing and we appreciate the effort of Senator Hollings, who, in drafting S. 1373, has provided a model for discussing the strength and efficacy of insurance regulation. This proposal reflects many of the provisions of California's Proposition 103, which have provided a stable and affordable insurance market for the past 15 years in California, a stark contrast to the skyrocketing prices and industry turmoil that characterizes the property-casualty marketplace in many other states.

While we believe that insurance regulation should remain the purview of state regulators, lawmakers and courts, we commend Senator Hollings for putting forward a compelling proposal to protect insurance consumers across the Nation. Senator Hollings proposal comes at a time when insurance companies are pushing to deregulate the insurance industry at the state level and by proposing an optional Federal charter system with rules that would allow insurers to choose their regulator in a manner that will undoubtedly reduce regulatory oversight of the insurance industry.

It is our belief that the most effective way to protect consumers and ensure reasonable insurance rates is through the tools of a prior approval insurance regulation system. Our research has shown that insurance company regulation, when properly implemented, can save consumers billions of dollars and maintain profitability within the insurance industry, thereby providing customers with the most choice in the market. In other words, the regimen of insurance regulation creates the environment that is most conducive to marketplace competition while also affording consumers necessary protection against insurance company profiteering.

In addressing the questions at hand, FTCR would like to present the following thesis:

Insurance products are such an integral part of the economic life of Americans, that ensuring both the affordability and quality of the products is crucial to the financial security and well-being of American consumers and businesses. Effectively regulating the insurance marketplace is the best way to produce reasonable and stable rates for consumers and appropriate market conduct by carriers

Our reports, analyses and experience have confirmed this thesis time after time over the 15 years since the enactment of Proposition 103 in California. To illustrate the success of and need for a strong regulatory regime for insurance, we bring together a variety of data and analysis in this testimony to make the following points:

I. Proposition 103 has saved California consumers billions of dollars through its prior approval regulatory structure, including more than $62 million saved for doctors and homeowners in the past two months alone as a result of FTCR's rate challenges.

II. Insurance follows an economic cycle inversely related to the Nation's financial markets. Aggressive investing practices have created volatility in insurance rates over the past five years, culminating in the massive price spikes and underwriting restrictions that appeared on the heels of the collapse of Enron, Worldcom and declining interest rates.

III. The antitrust exemptions provided to insurers are anti-competitive and allow companies to set prices collusively rather than compete on the insurers' actual abilities to assess and carry risks.

IV. Insurance companies project higher losses in order to push for higher rates and imply a crisis, and then quietly change their data in the years to come.

V. Tort limitations imposed during previous crisess have had no demonstrable effect on insurance rates.

Proposition 103 Regulation Saves Consumers Billions of Dollars

In 1988, California voters, facing skyrocketing insurance premiums and angry at the failure of tort reform to deliver its promised savings, went to the ballot box and passed Proposition 103, the Nation's most stringent reform of the insurance industry's rates and practices—applicable to all lines of property-casualty insurance, including auto, homeowners, commercial and medical-malpractice.

Proposition 103:

- *Mandated an immediate rollback of rates of at least 20 percent*—rate relief to offset excessive rate increases by establishing a baseline for measuring appropriate rates.
- *Froze rates for one year.* Ultimately, because of the delay caused by insurance company legal challenges to Proposition 103, rates remained frozen for four years pursuant to decisions by the state's insurance commissioner.
- *Created a stringent disclosure and "prior approval" system of insurance regulation,* which requires insurance companies to submit applications for rate changes to the California Department of Insurance for review before they are approved. Proposition 103 gives the California Insurance Commissioner the authority to place limits on an insurance company's profits, expenses and projections of future losses (a critical area of abuse).
- Authorized consumers to *challenge insurance companies'* rates and practices in court or before the Department of Insurance.
- *Repealed anti-competitive laws* in order to stimulate competition and establish a free market for insurance. Proposition 103 repealed the industry's exemption from state antitrust laws, and prohibited anti-competitive insurance industry "rating organizations" from sharing price and marketing data among companies, and from projecting "advisory," or future, rates, generic expenses and profits. It repealed the law that prohibited insurance agents/brokers from cutting their own commissions in order to give premium discounts to consumers. It permits banks and other financial institutions to offer insurance policies. And it authorizes individuals, clubs and other associations to unite to negotiate lower cost group insurance policies.
- *Promoted full democratic accountability* to the public in the implementation of the initiative by making the Insurance Commissioner an elected position.

A copy of the text of Proposition 103 are submitted as Appendix A.

Insurers spent $80 million in their unsuccessful effort to defeat Proposition 103, including the cost of sponsoring three competing ballot measures that would have enacted "tort reform." Having seen how "tort reform" laws passed at the behest of the insurance industry in 1975 and 1986 had had no effect on premiums, the voters rejected each of the industry's 1988 measures.

Proposition 103 worked. Insurance companies refunded over $1.2 billion to policyholders, including motorists, homeowners and doctors. In the closely studied area of auto insurance, California was the only state in the Nation in which auto insurance liability premiums actually dropped between 1989 and 2001, according to NAIC data. A 2001 study by the Consumer Federation of America concluded that the prior approval provision of Proposition 103 blocked over $23 billion in rate increases for auto insurance alone through 2000.

Despite the clear success of Proposition 103, the insurance industry continues to resist regulatory oversight and, instead pushes for less accountability and less intervention. The industry typically criticizes insurance regulation as slowing down the process of adjusting rates and introducing products that companies want to provide to consumers. Insurers argue for "speed to market" rules that would set a national standard of scrutiny; not surprisingly, that standard is far weaker than the regulatory strictures of Proposition 103 and the prior approval method of insurance ratemaking.

This professed goal of efficiency must be weighed next to the need to protect against high rates and low-quality products. Just as new drugs must be put through a battery of tests to ensure safety prior to being placed on the market, insurance products need to be fully vetted before they are sold to consumers. The prior approval structure of California's Proposition 103 gives the insurance commissioner and the public the ability to ensure that consumers have access to insurance products that provide high quality coverage and are not priced to gouge consumers.

A. Prior Approval and Consumer Participation Allow the Public to Scrutinize Insurers' Books, Hold Firms Accountable

The chief tool necessary to effectively regulate insurance companies is the right of government to approve, deny or alter insurance rates before companies can change consumers' rates. Of course, the quality of the regulator determines, at least in part, the efficacy of the regulation. As a safety valve against an understaffed or unwilling regulator, Proposition 103 provides the public with the opportunity to analyze and challenge rates and industry practices in the courts as well as before the agency in order to offer a competitive perspective on rate changes proposed by insurers. This tool of participation also serves as a way to hold the insurance commissioner accountable to the regulatory structure, by allowing the public to challenge rate hikes or practices that the Commissioner might have otherwise approved.

Proposition 103's prior approval system establishes a set of boundaries for insurance companies to use in setting rates for consumers. The formula includes limits on, or guidelines for administrative expenses, profits, the methods of projecting future losses and other aspects of developing a rate. Effective insurance regulation prohibits insurers from engaging in bookkeeping practices that inflate their claims losses and limits the amount insurers can set aside as surplus and reserves. It also forbids insurers from passing through to consumers the costs of the industry's lobbying, political contributions, institutional advertising, unsuccessful defense of discrimination cases, bad faith damage awards, and fines or penalties.

A prior approval system places the burden on the insurance company to justify its rates in advance, rather than on the consumer or regulator to find inappropriate rates after the fact and only then begin the process of scrutiny. It is our belief that pre-emptive regulation is far more efficient and fair than the alternatives.

A series of recent examples of the power of the prior approval system and the tangible benefit of consumer participation in California follow:

- On August 22, 2003, California Insurance Commissioner John Garamendi ordered the state's second largest medical malpractice insurer, SCPIE Indemnity, and its affiliate American Healthcare Indemnity, to cut it's proposed rate hike for physicians by 36 percent, in response to a rate challenge brought by FTCR. As part of the challenge, FTCR actuaries and insurance experts opened SCPIE's books to review the company's financial data and actuarial projections. FTCR also interviewed the firm's actuaries, economists and consultants in order to demonstrate that the insurer's proposed 15.6 percent rate increase was excessive.

  Instead of the company's proposed 15.6 percent increase that was originally set to go into effect on January 1, 2003, the Commissioner only allowed SCPIE and its affiliate to increase premiums by 9.9 percent beginning on October 1, 2003. The net impact is a $16 million savings for the insurer's 9,000 physicians in 2003 and an additional $7.2 million of savings in 2004 premiums. (SCPIE has applied for an additional 2004 increase that FTCR will likely challenge.)

  According to the decision issued by the commissioner, SCPIE tried to justify its rate hike by claiming that it should not be subject to a strict application of rate regulations and that it did not have the burden of proving its rates were reasonable, despite California's clear regulatory requirements. The Commissioner rejected that argument and, to ensure regulatory compliance by SCPIE and other insurers, officially designated portions of his ruling as legal precedent.
- FTCR challenged a recent 9.9 percent increase proposal by the state's largest medical malpractice provider, NORCAL Mutual. The ensuing scrutiny by California Department of Insurance regulators, led the company to slash its rate request by 70 percent, resulting in a $11.6 million savings to NORCAL-insured doctors.
- Using the consumer participation tools of Proposition 103, FTCR recently blocked a 10 percent rate hike for homeowner's insurance policyholders with the Northern California Auto Club, the state's fourth largest homeowner's insurance provider. This resulted in a $26 million savings for the company's 330,000 policyholders.
- In 1998, FTCR challenged a rate decrease proposal by auto insurer Allstate. The Commissioner allowed the company to reduce rates, but FTCR's analysis indicated that rates should have dropped further. In response to our challenge, Allstate agreed to reduce its auto insurance premium by $43 million in addition to the reductions associated with its initial rate decrease proposal.

To ensure that the public is able to effectively intervene and challenge inappropriate insurance rates and practices, Proposition 103 requires insurers to reimburse

consumers or consumer representatives when the group contributes to a decision rendered by the Insurance Commissioner with respect to rates. Pursuant to Proposition 103, consumer groups are also provided funding for participation in all aspects of insurance regulation. This has allowed groups acting on behalf of consumers a reasonable opportunity to enforce the rules set forth in Proposition 103.

B. Auto Insurance: Regulation Protects Consumers From a National Trend

In the years since the implementation of Proposition 103, auto insurance rates in California have defied the national upward trend. The following tables summarize insurance industry data drawn from annual reports published by the National Association of Insurance Commissioners.[1] We provide an analysis of data for the years 1989–2001, encompassing the entire period following the implementation of Proposition 103 for which data is available.

The average auto liability premium ***dropped*** *22 percent in California between 1989 and 2001.* Prior to Proposition 103, auto insurance premiums in California rose dramatically each year. Pre-election rate increases by insurance companies in anticipation of Proposition 103's passage, and post-election rate increases taken while Proposition 103 was stayed pending California Supreme Court review, pushed the average liability premium in California to $519.39 by 1989.

According to the latest NAIC data, California's average auto liability insurance premium for 2001 was $404.48—22 percent *less* than the 1989 figure. The average premium decrease in California becomes even more striking when adjusted for inflation.[2] The average premium in 1989, in 2001 dollars, was $741.81. In comparison, the average California auto liability premium in 2001 was *45 percent lower.*

Comparison of Average Liability Premiums, 1989–2000

Year	California Premium	California Premium (2001 dollars)
1989	$519.39	$741.81
1990	$501.34	$679.32
1991	$522.95	$679.99
1992	$510.71	$644.67
1993	$512.52	$628.15
1994	$502.76	$600.80
1995	$514.53	$597.92
1996	$508.71	$574.20
1997	$492.31	$543.23
1998	$447.51	$486.22
1999	$405.85	$431.43
2000	$391.24	$402.37
2001	$404.48	$404.48

While auto premiums in California ***fell 22 percent, premiums throughout the rest of the Nation rose 30.2 percent.*** Another measure of the impact of Proposition 103 is a comparison with average liability premiums in other states. While liability premiums for the rest of the country grew 30.2 percent since 1989, California's *dropped* 22 percent. Tables 2 and 3 below compare California's average premium to the rest of the Nation's average.

Comparison of Average Liability Premiums, 1989–2000

Calculation is liability premiums/liability written car-years

Year	California	Rest of Nation[3]
1989	$519.39	$317.32
1990	$501.34	$338.55
1991	$522.95	$358.82
1992	$510.71	$381.69
1993	$512.52	$400.80
1994	$502.76	$411.40
1995	$514.53	$419.45
1996	$508.71	$431.45
1997	$492.31	$434.17
1998	$447.51	$423.39
1999	$405.85	$402.60
2000	$391.24	$398.44
2001	$404.48	$413.13

[1] *State Average Expenditures & Premiums for Personal Automobile Insurance* 1993–2001, National Association of Insurance Commissioners

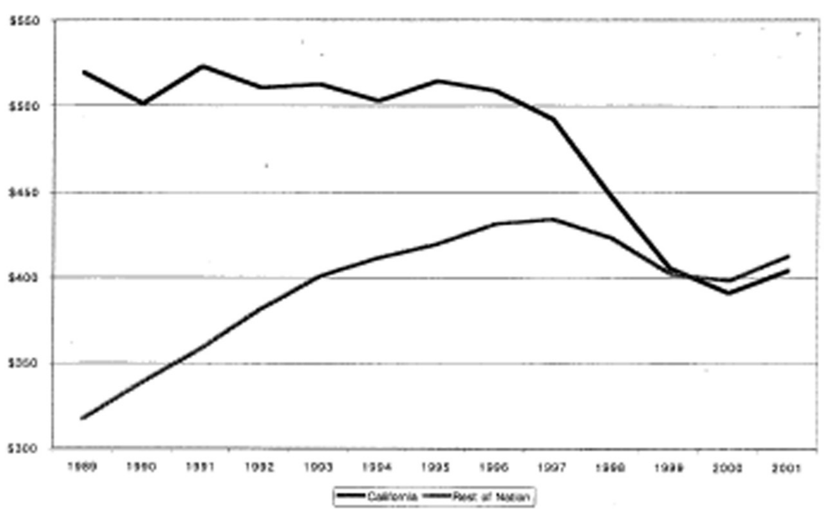
[2] The Bureau of Labor Statistics Inflation Calculator can be accessed at *http://data.bls.gov/cgi-bin/cpicalc.pl.*

Comparison of Growth/Decline in Average Liability Premiums, 1989–2000

Period	California % Change	Rest of Nation % Change
1989–90	–3.5%	6.7%
1990–91	4.3%	6.0%
1991–92	–2.3%	6.4%
1992–93	0.4%	5.0%
1993–94	–1.9%	2.6%
1994–95	2.3%	2.0%
1995–96	–1.1%	2.9%
1996–97	–3.2%	0.6%
1997–98	–9.1%	–2.5%
1998–99	–9.3%	–4.9%
1999–2000	–3.6%	–1.0%
2000–2001	3.3%	3.7%
1989–2001	–22.1%	30.2%

This sharp drop in California's average premium relative to that of other states brought California's rank down from the 2nd highest rates in the Nation in 1989 to 22nd in 2001.

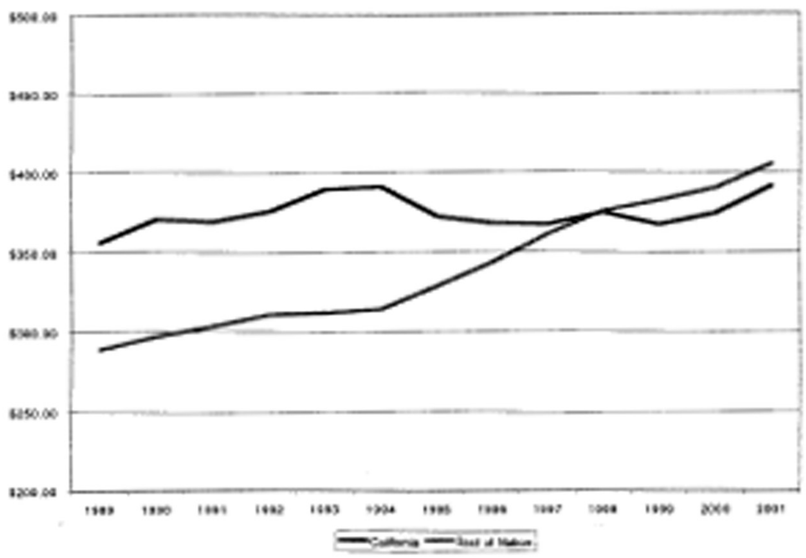
Comparison of Growth in Average Liability Premiums, 1989–2000
Comparison of Premiums 1989–2001



California's overall post-Proposition 103 premium decline defies national trend toward higher rates. In addition to lowering auto liability premiums, Proposition 103 has slowed premium growth for other types of automobile coverage at the same time that the rest of the Nation saw its premiums increase drastically. California's comprehensive premiums have fallen 10 percent while comprehensive premiums for the rest of the Nation have shot up by 40 percent. Collision premiums in California have gone up 20 percent, in contrast to the rest of the country's 40 percent.

[3] In this table and in subsequent tables, "Rest of Nation" data do not include California data.

Comparison of Average Combined Collision and Comprehensive Premiums, 1989–2001



Combined liability, collision and comprehensive premiums are down 9.2 percent for Californians, up 35 percent nationally since Proposition 103. In 1989 Californians paid $875.60 for liability, collision and comprehensive combined coverage on average. Nationwide consumers paid $606.40 for the combined coverage. However, with Proposition 103 in effect, California drivers' fortunes have changed, as combined average premium in California 2001 was $795.36, a 9.2 percent decline while nationally, motorists paid $817.87, a 34.9 percent increase

C. Insurance Regulation Has Allowed California To Be A More Profitable Market For Insurance Companies Than The National Average, While Keeping Rates Low

Despite the insurance industry's automatic negative reaction to insurance regulation, California under the strict regulation of Proposition 103 has been a more profitable environment for insurers than the Nation as a whole. According to the most recent data available from the National Association of Insurance Commissioners, in the majority of lines of insurance returns are better in California than countrywide.[4]

Whether one compares return on net worth or profit on insurance transactions (both are measures of profitability used by NAIC), the findings consistently show that California is generally more profitable for insurers than the Nation as a whole.

Table 7. Insurer Profitability in California vs. Countrywide Average

Return on Net Worth	10 Year Average 1992–2001	
Line of insurance	California	Countrywide
Private Passenger Auto (Total)	13.7%	9.8%
Homeowners Multiple Peril	5.7%	(3.4%)
Commercial Auto (Total)	10.0%	7.2%
Farmowners Multiple Peril	7.3%	0.9%
Medical Malpractice	12.5%	9.6%

[4] *Profitability by Line by State In 2001,* National Association of Insurance Commissioners, December 2002.

Notably, workers compensation has not been as profitable in California as that line has been nationally. Workers compensation insurance, however, was deregulated in California in 1993 and is in crisis currently.

California has been a profitable marketplace for insurers specifically because of the regulatory regime. Regulation serves to restrain the companies from damaging themselves as well as hurting consumers. Insurance regulation is not meant to produce the lowest premiums, it is meant to produce the most appropriate premiums for the risk insured; insurance regulation guards against both excessive and inadequate, as well as unfairly discriminatory rates. As a result, regulated lines of insurance result in more stable rates for customers, even if they are not the lowest prices at certain points in time.

The stable profitability associated with regulatory controls creates an environment in which insurers want to sell in the state. That is why there are so many insurers serving California customers. There are over 200 companies selling auto insurance in California, 150 selling homeowners and almost 50 selling medical malpractice insurance.

II. The Insurance Cycle and the Impact of Enron, WorldCom and Low Interest Rates

Over the last three decades-plus, the Nation has experienced three major insurance crises, in the mid-1970s, the mid-1980s and the early 2000s. Each of these crises swept the Nation with massive rate increases, insurers pulling or threatening to pull out of local markets and a legislative push for changes to tort laws. Each of these crises also occurred at the same time as a national downturn in the economy that dramatically reduced insurance company investment returns.

A. The Insurance Cycle

The present insurance “crisis”—apparent in homeowners, auto, commercial liability as well as medical and other malpractice lines—constitutes the apogee of a financial cycle to which the insurance industry is constantly subject. As one consumer organization explains:

> Insurers make most of their profits from investment income. During years of high interest rates and/or excellent insurer profits, insurance companies engage in fierce competition for premium dollars to invest for maximum return. Insurers severely underprice their policies and insure very poor risks just to get premium dollars to invest. This is known as the “soft” insurance market. But when investment income decreases—because interest rates drop or the stock market plummets or the cumulative price cuts make profits become unbearably low—the industry responds by sharply increasing premiums and reducing coverage, creating a “hard” insurance market usually degenerating into a “liability insurance crisis.” A hard insurance market happened in the mid-1970s, precipitating rate hikes and coverage cutbacks, particularly with medical malpractice insurance and product liability insurance. A more severe crisis took place in the mid-1980s, when most liability insurance was impacted. Again, in 2002, the country is experiencing a “hard market,” this time impacting property as well as liability coverages with some lines of insurance seeing rates going up 100 percent or more.[5]

Fitch, a Wall Street rating firm, recently began a discussion of the current “crisis” by harkening back to the last one:

> We need to look back at the hard market of the mid-1980s. . . . The last major hard market turn was in the mid-1980s, and was inspired greatly by a sharp drop in interest rates. In years prior to the mid-1980s, cashflow underwriting was prevalent in which a significant amount of naive capital was attracted to the property/casualty industry on the lure of making strong investment returns on the premium “float” between the time premiums were collected and claims were paid. Naturally, much of the naive capacity was directed at long-tail casualty and liability lines at both the primary and reinsurance levels in order to maximize the float. In the early 1980s, nominal interest rates were running in the mid-teens. When interest rates dropped off and significant reserve deficiencies were simultaneously detected, many insurers suffered large losses to both earnings and capital. The result was a sharp turn in the market, especially in long-tail lines, and the emergence of a so-called “liability insurance crisis.”

[5] “Medical Malpractice Insurance: Stable Losses/Unstable Rates,” Americans for Insurance Reform, October 10, 2002.

> The liability insurance crisis included a sharp drop in availability of coverages, and huge price increases (in many cases several-fold).[6]

Indeed, by early 2002, insurers had already begun licking their chops as they looked forward to an infusion of profits from the latest "crisis." In its "Groundhog Forecast 2002," the Insurance Information Institute projected a 14.7 percent increase in premiums, the industry's "fastest pace since 1986"—the last crisis.[7] The Auto Insurance Report proclaimed, "The Stars Are Lining Up for Solid Profits in 2002–2003."[8] "How Much longer to P–C Nirvana?" asked the National Underwriter, saying, "Like kids on a long car trip headed for summer vacation, many insurance company employees and the agents that represent them have found themselves wondering just how much longer this trip to property-casualty nirvana can last."[9] Said an industry executive: "This manic behavior leads our customers to believe we don't know what we're doing, and I think they have a point. This is a generation of insurance professionals who need to learn how to be successful with something other than low premiums."[10]

B. Interest Rates and the Cycle

The current push for higher insurance rates is driven in part by the historically low interest rates. There is an inverse relationship between interest rates and insurance rates and, as the graph below illustrates, when interest rates go down a crisis ensues and, inevitably, rates increase.

When Interest Rates Fall, A Crisis Ensues

Over the past three decades, there has been an insurance crisis and a concurrent spike in insurance premiums each time the Nation has experienced a major decline in interest rates. The notable exception to this is when interest rates dipped in 1992. Still reeling from California's adoption of Proposition 103 after the 1980s crisis, the insurance industry aborted another run-up in prices in 1992 and 1993 despite the declining economy and interest rates. As one insurance executive explained, "The last soft market was driven purely by the need for cash to invest. . . . We all know we can't do the dumb things we did last time. . . . We will not see

[6] Fitch Ratings, Inc., Insurance Special Report Review & Outlook: 2001/2002: U.S. Property/Casualty Insurance, January 17, 2002, p. 19–20.

[7] *www.iii.org/media/industry/financials/groundhog2002/* visited 11/21/02.

[8] Auto Insurance Report, May 13, 2002, p. 1.

[9] National Underwriter, July 22, 2001, p. 26.

[10] "Liability Insurers Urged to Take Long View for Industry's Financial Health," Orlando Business Journal, November 26, 2002 at *http://orlando.bizjournals.com/orlando/stories/2002/11/25/daily25.html?t=printable.*

a repeat of 1985–86."[11] Arguing against a push to raise rates, a senior officer at the Insurance Services Office, an industry data provider, said: "Remember the fall-out from the last recovery: California's Proposition 103 and other price-suppression laws, threats to the industry on the antitrust front, and virulent consumer hostility."[12]

Despite its apparent awakening after the passage of Proposition 103, the insurance industry has fallen into its old ways in recent years, as the most recent insurance-cycle crisis and the ensuing rate increases have been particularly aggressive.

In this crisis as with previous crises, insurers have made it difficult for consumers to obtain and maintain coverage. After the very liberal underwriting practices of the mid 1990s, in which obtaining coverage was not particularly difficult for consumers and businesses, the trend over the past two years has been to shut consumers out of the insurance market by implementing very restrictive underwriting guidelines.

Increasingly, companies are punishing policyholders—especially in the homeowners insurance market—for having filed legitimate claims. In fact, during this crisis, insurers have begun to drop customers simply for inquiring with their insurer about a possible claim, even if they do not file a claim. Additionally, using the national claims database known as the Comprehensive Loss Underwriting Exchange (CLUE), insurers have been denying policies to consumers who have previous claims or even mere inquiries, regardless of the nature of the claim.

C. The Role of Enron, Worldcom and the Corporate Scandals of 2001–2002

While internally acknowledging the insurance cycle and the role of investments, particularly in mandatory financial filings, the insurance industry has largely blamed factors such as higher medical bills, increased labor costs, litigation costs and jury awards when it presents its view of the insurance market to lawmaers and the public generally. The industry does not, unfortunately, blame Enron and WorldCom for rate hikes. More importantly, the companies do not blame themselves and the insurance executives who decided to risk a growing percentage of policyholder premiums on investments in Enron, WorldCom and other corporations. They should. And insurance commissioners should hold insurance companies accountable for the billions of policyholder premium dollars that have been squandered as a result of risky investment practices.

Ten property and casualty insurance companies reviewed by FTCR lost a combined $274.1 million in 2001–2002 as a result of investments in *the big five frauds*—WorldCom, Enron, Adelphia, Global Crossing and Tyco.[13] State Farm, for example, lost more than $74 million as a result of that company's investments in Enron and WorldCom alone.

1. Americans are more exposed to corporate corruption than they think

With the excitement surrounding the stock market bubble of the 1990s, insurance companies increasingly invested in private corporations. Typically, insurance industry executives assert that company portfolios are largely tied up in municipal and other government bonds, with only limited exposure to corporate America. However, by 2001, the particularly disgraced energy, high-tech and telecom sectors figured heavily in insurance companies' portfolios. As a result of this indulgence in higher risk investments, the spate of recent corporate scandals and the insurers' investment follies significantly impacted consumers, whose premium dollars have been placed in insurance company portfolios replete with stocks and corporate bonds.

In a 2002 study, FTCR identified billions of premium dollars lost as a result of changes in property and casualty insurers' investment strategies.[14]

Among FTCR's findings:

- *State Farm Mutual Auto* lost $60.7 million on *WorldCom* investments in 2002 and $42.6 million associated with its *Tellabs* holdings.
- *Allstate* lost $23.3 million when it shed several hundred thousand shares of *Tyco* stock as the public became aware of Tyco CEO Dennis Kozlowski's alleged criminal fraud in the first half of 2002. The insurer also lost $11.7 million when

[11] Business Insurance, July 13, 1992, p. 55

[12] Insurance Week, Oct. 19, 1992, p.15

[13] The companies reviewed include: Allstate Insurance Company, Auto Club of Northern California, Auto Club of Southern California, Farmers Insurance Exchange, Fireman's Fund, Liberty Mutual Insurance Company, Mercury Casualty Company, Nationwide Mutual Insurance Company, State Farm Mutual Auto, United Services Automobile Association.

[14] All data are based on Annual Statements of insurers filed with the California Department of Insurance. Calculations of stock and bond holdings are based on the actual cost of the investments (see also footnote 8).

it discarded *Quest Communications* stock, another firm investigated by the SEC for its accounting practices.

- *Fireman's Fund* wrote off the entire cost of its *Winstar* stocks and bonds—$85.4 million –after that wireless communications company filed for bankruptcy in April 2001. Additionally, the insurer took a $28.6 million hit on *WorldCom.*

The Enron factor:

- *Enron,* the company whose fraudulent accounting and subsequent bankruptcy inaugurated the current era of corporate scandals, was held by many of the insurers reviewed for this analysis. In 2001, Enron losses cost *State Farm Mutual Auto* $13.5 million, *Farmers* $9 million, *Fireman's Fund* $6.2 million, *Northern California Auto Club* $4.4 million, *United Services Automobile Association* $4.3 million and *Allstate* $3.6 million. *Fireman's Fund* continued to hold $5 million dollars in Enron bonds into 2002.

2. Insurers Change Investment Strategies in the late 1990s

FTCR studied investment data for ten major insurers between 1998–2001. The study also examined available 2002 data, and reviewed data going back to 1994 for four companies exhibiting the riskiest investment behavior.

For this analysis, FTCR reviewed public filings to measure the percentage of an insurer's portfolio that is invested in stocks (both common and preferred) and corporate bonds.[15] Real estate holdings, which are reported separately from stock and bond holdings, were not reviewed.

Nine of the ten companies reviewed increased their level of investment in the corporate sector between 1998 and 2001. The companies' holdings in 1998 consisted on average of 48 percent stocks and corporate bonds combined, with the rest invested in government bonds. By 2001, the average percentage invested in corporate America was up to 57 percent—a 19 percent increase in the size of insurers' corporate investments relative to their overall portfolios. At the end of 2001, seven of the 10 companies for which FTCR obtained data had over 50 percent of their investments in stocks and corporate bonds.

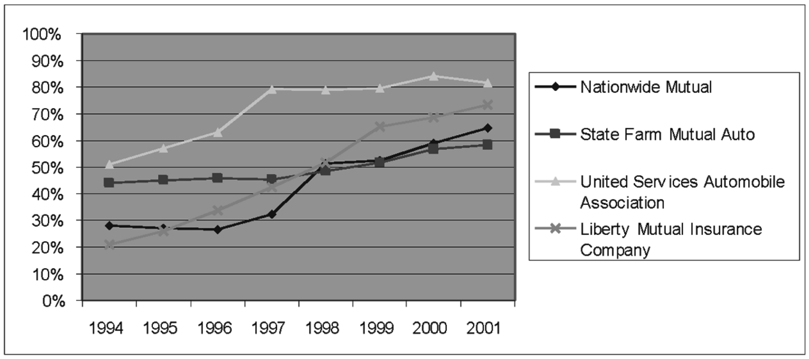
For four of the companies that had most heavily invested in the stock and corporate bond markets in 2001—USAA, Liberty Mutual, State Farm and Nationwide—FTCR analyzed portfolios for an extended period, 1994–2001, and found that the companies had greatly increased investments in the corporate sector relative to their overall investments.

- In 2001 United Services Automobile Association had more than four-fifths of its entire portfolio—82 percent—invested in the corporate sector. This represents a 61 percent increase in the companies' investments in corporations since 1994.
- Corporate investments accounted for 73 percent of Liberty Mutual's portfolio in 2001, representing a 248 percent increase over the insurer's 1994 corporate investments, which accounted for 21 percent of its portfolio
- State Farm Mutual Auto's percentage was 58 percent in 2001, a 32 percent increase over its level of corporate investing before the company jumped into the nineties stock bubble.
- Nationwide Mutual's ratio of corporate investments to its overall holdings jumped 37 percentage points over this period to 65 percent—a 132 percent increase.

The following graph shows the rise in the percentage of these companies' portfolios tied up in corporate sector investments.

[15] This percentage was calculated using the actual cost of insurers' investments, also known as the purchase price. The purchase price of the insurance companies' stock and bond holdings in a given year remains constant, while other measures—such as book value—may fluctuate. Moreover, the actual cost of the investments is useful in that it shows how the companies in this study chose to allocate their investment dollars over the years. In other words, if a given company's level of investment in corporations grew over the period of the study, it was not due to rising values of previously purchased stocks and corporate bonds. The use of the actual cost value is also consistent with the losses on stock and bond sales and write-offs listed below, which are calculated based on the initial purchase price of the investments.

Corporate Investment as a percent of Investment Portfolio 1994–2001



3. Heavy in Stocks

It is important to note that a large portion of corporate holdings is invested in stocks and not in the generally more stable corporate bonds.

The stock investments of the ten companies reviewed averaged 37 percent of their overall investments in 2001, eight percentage points more than 1998 levels. United Services Automobile Association invested more than half of its portfolio –57 percent—in stocks alone (up from 40 percent in 1994). Nationwide Mutual was close behind with 46 percent (the company invested only 25 percent in stocks in 1994), and State Farm Mutual Auto's stock holdings represented 43 percent of its portfolio (compared to 27 percent in 1994). 42 percent of Liberty Mutual's holdings were in stocks in stocks in 2001, up from 10 percent in 1994.

4. Insurers' Major Losses

Insurance portfolios are replete with corporate stock and bond picks that chronicle the recent bankruptcies, earnings restatements and fraud indictments. A glance at stock and bond transactions in 2001 for a handful of big insurance companies illustrates why investment income fell dramatically by remaining too heavily invested in the stock and corporate bond markets.

The 2001 figures below represent the sum of the amounts lost by a given insurer on all transactions of a given company's stocks and bonds for the entire year, 2001.

A Selection of Insurers' Major Stock and Bond Losses in 2001 [16]:

Allstate	Fireman's Fund
• Adelphia: $1.1 million [17] • AOL/Time Warner: $2.2 million • Cisco: $6.9 million • Enron: $3.6 million • Global Crossing: $5.9million • Qwest: $11.7 million • WorldCom/MCI: $2.4 million	• Broadcom: $31.2 million • Cisco: $26.3million • Enron: $6.2 million • WorldCom/MCI: $28.6 million • Winstar: $85.4 million
Farmers	Nationwide
• Enron: $9 million • Dynegy: $1.1 million	• Enron: $734,513 • EMC Corp.: $4 million • Compaq: $1.2 million
State Farm	USAA
• Enron: $13.5 million • Level 3 Communications Inc: $55 million • Bank of America: $29.1 million • XO Communications Inc.: $19.8 million • Battle Mountain Gold: $9.9 million	• Enron: $4.3 million • JDS Uniphase (telecom supplier): $7.6 million • USAA emerging markets fund: $63.6 million (fund heavily invested in international energy and telecommunication stocks)

The data reviewed for the first two quarters of 2002 show equally precipitous declines in the portfolios of major insurers with particularly dramatic losses resulting from WorldCom and Tyco holdings.

The investment losses and other data detailed above are not meant to be exhaustive. They paint a picture, rather, of the sort of investment failures that have cut into insurance companies' profitability in recent years and led to a national run-up in insurance rates.

In light of these findings, it is useful to review the preamble to the International Association of Insurance Supervisors' "Supervisory Standard on Asset Management by Insurance Companies," which reads:

> In order to ensure that an insurer can meet its contractual liabilities to policyholders, such assets must be managed in a sound and prudent manner taking account of the profile of the liabilities held by the company and, indeed, the complete risk-return profile.[18]

Instead of following these standards, we have found that insurance companies ignored their responsibility and jumped headlong into the stock market bubble—only to fall hard when it burst with the string of frauds and bankruptcies that decimated the Dow and NASDAQ.

The mismanagement of policyholder premium, however, has been largely ignored as companies simply replenish the dissipated investments through rate hikes.[19] As a result of insurers' increased exposure to corporate risk during this insurance cycle, the impact of corporate fraud on companies and, in turn, policyholders was far greater than should ever have been expected.

Not surprisingly, with the recent rebounding of the stock market, it is becoming evident that insurers wish to start selling more policies in order to gain investment capital. Companies that earlier this year had committed to reducing exposure and refusing to sell insurance are once again entering the market and selling new policies. If the stock market continues this expansion, and especially if interest rates increase, a loosening of the insurance market—a stabilizing and possibly lowering of rates as well as a liberalizing of underwriting practices—is inevitable.

It is not, however, good public policy to allow insurers to foist these economic cycles onto individual consumers and business consumers of insurance by allowing the rating and underwriting chaos that consumers have endured in recent years. Unregulated, or loosely regulated insurance companies will invest recklessly, knowing that the firms can simply pass through their investment mistakes and troubles.

Under this system, individuals and businesses face unnecessary premium volatility as rates follow the investing cycles: when insurers' investment returns are high rates will drop and when investment returns drop, rates increase, and when the stock market, bond market and interest rates all collapse at once rates will skyrocket. Furthermore, without regulatory oversight to enforce more responsible practices, consumers bear much more of the burden of bad economic times than they gain in benefits during the good times.

III. The Insurance Industry Should Be Subject To Antitrust Laws

In 1945 the McCarran-Ferguson Act exempted the insurance industry from Federal antitrust laws and in subsequent years the insurance industry won antitrust exemptions from virtually every state. As a result, insurer-controlled "rating bureaus" freely distribute proposed pricing data, including projected losses, expenses, profits, and overhead charges, to all insurers who wished to obtain the information, allowing tacit price collusion.

As a result of this exemption, insurers are able to fix rates through the use of advisory rates established by an insurance industry owned organization, the Insurance Services Office (ISO). The ISO projects loss trends, allowing insurers to share data and projections for pricing rather than requiring companies to develop product

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[16] All of a given company's publicly traded units are grouped for the purposes of this report. For example, "WorldCom" includes MCI and WorldCom, "AOL/Time Warner" includes AOL and Time Warner, etc. "Williams" includes Williams Cos. and Williams Communications Group, due to the Energy company having been the owner of the Communications subsidiary during a portion of the period covered by this report and the continuing close affiliation between the two companies.

[17] Figures for stock and bond losses are based on total net gain/loss from all transactions of the given issuer's stocks and bonds, and/or basis adjustments for bonds, for each insurer.

[18] "Supervisory Standard on Asset Management by Insurance Companies,"International Association of Insurance Supervisors. Approved December 1999

[19] Insurance companies maintain significant surplus, beyond what is reserved to pay losses, that could be tapped to cover claims if there is a shortfall due to failed investments of policyholder premium.

pricing competitively. As a result of the anti-competitive environment, insurers know that they can price insurance too low when, for example, investment returns are high, because the companies know that the industry can act in concert to raise prices at a future date. Without the antitrust exemption, insurers would need to price more responsibly and based on their actuarial needs because they would not be assured of the higher future prices that collusion allows.

Proposition 103 repealed the insurance industry's exemption from the antitrust laws in California and prohibited the operation of "rating" and "advisory" organizations set up by the industry to circulate pricing and policy information to insurance companies.

There is no reason to maintain this exemption from the Nation's antitrust laws elsewhere, as there is no reason to provide the industry with anti-competitive tools that allow it to act collusively against the interest of consumers. The antitrust exemption should be repealed.

IV. Insurance Companies' Loss Estimates Are Inflated

The insurance industry bases rates on a series of actuarial analyses and calculations. A key data set in these calculations is the incurred losses that insurers report on an annual basis. Incurred losses represent the projected payments a company will make for claims filed in a given year. These projections are based on a combination of the assessed value of those claims that have been filed as well as those that have not yet been filed, but the insurer expects, known as "incurred but not reported" losses. In short, the data reported annually as "incurred losses" are estimates of losses that are meant to be an insurer's best guess as to their liabilities for the year.

The "best guess" data are used to assess a company's financial condition, to develop new rates and, often, the data are used as fodder for legislative efforts to push changes in tort law. FTCR has recently analyzed fifteen years of loss projections in the field of medical malpractice insurance and found that companies dramatically and consistently exaggerate incurred losses initially, only to adjust the losses downward in future years.

According to the data (we have reviewed reported losses since the beginning of the last insurance crisis in 1986), malpractice insurance companies have historically inflated their loss projections and then revised their reported losses downward in subsequent years. The research shows that the "incurred losses" that medical malpractice insurance companies initially report for policies in effect in each of the years examined were, on average, 33 percent higher than the amount they actually paid out on those policies.

We have also found that insurers' reported losses were significantly inflated during the "insurance crisis" of the late 1980s. In 1989, for example, medical malpractice insurers' loss estimates were overstated by 40 percent. Based on this investigation, the "incurred loss" data reported by medical malpractice insurers do not represent, or even approximate, the actual losses a company will sustain as a result of claims against its policyholders.

It is, therefore, our view that policymakers must not rely upon the insurance industry's current loss projections, because those figures are not based on hard or otherwise reliable data. In order to protect the public from the abuse of unreliable accounting practices, new regulatory and accounting reforms are needed. Additionally, regulators and law enforcement officials should seek to resolve the outstanding question as to whether insurance companies have simply failed to find accurate tools for projecting losses or are intentionally inflating their reported losses.

A. Incurred Losses vs. Actual Losses

The distinction between "incurred" and actual losses, commonly known as "paid losses," is central to understanding an insurance company's true financial condition and to evaluate the losses insurers report. It is a distinction insurers do not often make in public debate.

Insurers calculate their rates for a given year based on their "incurred losses" for that year. When insurers say they have an "incurred loss" of a certain amount in a given year, however, they do not mean that they have actually paid out that amount in that year. Rather, they mean that they *estimate* that they will ultimately pay out that amount on claims they predict they will receive that are covered by policies in effect in that year. In other words "incurred losses" represent projected losses. Thus, if an insurer reports in 2003 that its "incurred losses" for 2002 were $100, the insurer has not paid out $100 for 2002 claims. Rather, the insurer estimates that it will ultimately pay out—over a period of several years—$100 for claims covered by policies in effect in 2002.

An insurer's "incurred losses" are, therefore, by definition, a guess. Statistical and mathematical methodologies have been developed which, using standard actuarial techniques, can be applied to make that guess an educated one. However, absent a regulatory formula that both mandates the use of such techniques and reviews insurers' compliance, insurers have enormous discretion in determining incurred losses.

Each year, the insurer receives more information about the "incurred losses" it had guessed it would ultimately pay for claims covered by policies in effect in a previous year. As time goes on new claims are reported to the insurer, the insurer receives more details about existing claims, and the insurer ultimately pays a specific amount—or no amount—on each claim. As it receives this new information, the insurer adjusts the original guess it made. The more time that elapses, therefore, the less guesswork is involved and the more accurate an estimate for a previous year becomes.

In medical malpractice, the average claim is paid approximately 5 and 1/2 years after the claim arises; most claims are paid within 10 years. An insurer's estimate of its true liability for claims it guesses it has incurred in a given year is therefore substantially accurate after 10 years.

Projecting the number of claims an insurance company must pay out, and the amount of those claims, and setting rates based on these guesses, is inherent in the nature of the insurance business. In exchange for a premium an insurer receives from an insured in the present, the insurer agrees to pay claims against that insured in the future; there is no way for the insurer to know at the time it receives the premium exactly how much it will pay for claims against the insured, nor even whether there will be any claims against that insured at all.

Insurers therefore may not fairly be criticized for estimating their future losses and changing those estimates every year—that is the nature of the business.[20]

Insurers may fairly be criticized, however, when they mischaracterize these *estimates* of future losses as *actual* losses—which they do frequently. For example, the most commonly used measure of success in the insurance industry is the loss ratio: the ratio of an insurer's incurred losses in a given year to its earned premiums in that year. While the earned premium number is a hard number and does not meaningfully change over time, the incurred loss number is a guess. Yet insurers discuss the loss ratio as if each number were a hard number. For example, if an insurer reports a loss ratio for 2002 of, say, 110, it typically characterizes itself as actually paying out $1.10 for each premium dollar it takes in in 2002. The implication is that the company is losing money. In fact, it has not paid out $1.10 in 2002, but only guessed that when a final accounting of 2002 claims is completed years later, it will have paid out $1.10.

For example, here is how the Florida coalition of insurance companies, hospitals and the medical lobby characterize the industry's financial status:

> In 2001, medical liability insurers nationally paid out $1.40 for every $1.00 they received in premiums.[21]

In fact, this dire portrayal is based on incurred losses, and is, by definition, only an estimate of what insurers will pay out in the future. Yet the statement expressly—and falsely—states that that amount was *paid out.*

Similarly, the North Carolina Access to Quality Healthcare Coalition discussed North Carolina's medical malpractice incurred loss ratio of 113 for 2001 as follows:

> "In 2001, according to NAIC data, North Carolina professional liability *insurers paid $1.13 in claims for every $1 in premiums they received.*" (Emphasis in original). (Fact sheet, N.C. Access to Quality Healthcare Coalition).

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[20] Indeed, insurance companies employ their own "statutory accounting principles" (SAP)—a departure from the "generally accepted accounting principles" applicable to all other industries in the United States—in recognition of their need to make loss projections. Under SAP accounting practices, insurers not only report incurred losses to regulators for purposes of justifying rate increases and decreases. They are also permitted to treat incurred losses as real losses for tax purposes. Although the IRS theoretically has the authority to impose penalties for grossly overstated loss reserves, as a practical matter it never imposes such penalties. See, *e.g.,* K. Logue, Toward a Tax-Based Explanation of the Liability Insurance Crisis, 82 Va. L. Rev. 895, 917–18; R. Morais, Discounting the Downtrodden, Forbes, Feb. 25, 1985, at 82–83 ("It is virtually impossible on a case-by-case basis to prove reserve redundancy") (quoting Larry Coleman, analyst for National Association of Insurance Commissioners).

[21] Heal Florida's Health Care, fact sheet available at *http://www.healflhealthcare.org/heal__FLhealthcare/homepage.html.*

Again, the numbers are referring to incurred losses, and insurers only *estimated* that they will pay out $1.13. Again, the insurance industry incorrectly states that that amount was *paid out.*

The description of projections as actual payments is false, and it is a misrepresentation that has misled policymakers, the news media and the public.

The difference between an insurer's initial estimate of its incurred losses for a given year's policies and the amount of its actual losses on that year's policies has important implications for the current medical malpractice insurance debate. This is because the rates an insurer charges for a given year are necessarily based on its incurred loss estimates for claims covered by that year's policies, not on its ultimate paid losses on that year's policies. Thus, if the amount an insurer ultimately pays out for claims covered by a given year's policies is less than the amount the insurer initially estimated it would pay out for claims covered by those policies, the insurer's rate (and the premiums paid by policyholders) for that year would have been too high. Similarly, if the amount the insurer ultimately pays out is more than the amount the insurer initially guessed it would pay out, the insurer's rate for that year would have been too low.

It should be obvious that in a weakened economy such as today's, insurance companies stand to gain by reporting sudden and substantial increases in incurred losses. Such increases are used to justify sudden spikes in premiums, such as those in the current malpractice marketplace. They also provide tax breaks for insurers. And the increased estimates of incurred losses are the foundation of the industry's argument that only by enacting tort reform will premiums go down.

Whether the insurer charged a rate that was too low or too high, and the amount by which that rate was too low or too high, cannot be known with confidence until 10 years after the insured pays the premium. Whether the rates doctors are being charged in 2003 for medical malpractice insurance are too low or too high, therefore, will not be known for certain until 2012.

Unfortunately, there is no opportunity to go back ten years and lower rates that, in hindsight, proved to be too high.

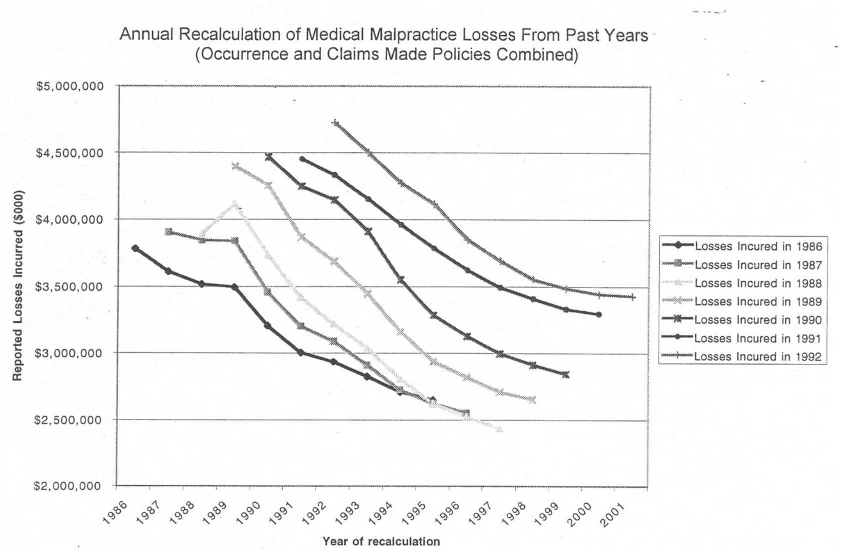
Nor is there any way to retroactively repeal the application of tort law restrictions put in place at the behest of the industry based on loss estimates that turned out to be far in excess of reality.

B. Data Show Companies Overestimated Losses

After 10 years of claims information being reported to insurers and incurred losses being restated, the initial incurred loss estimated for each year from 1986 through 1992 by the medical malpractice insurance industry has proved to be at least 26 percent overstated. (Except where stated, these figures reflect an analysis of "claims made coverage" a common form of medical malpractice insurance.)

- During the key crisis years—1986 through 1990—incurred losses were initially estimated to reach $10.7 billion. Ten years later the reported losses for that period totaled $7.1 billion, meaning that original loss estimates during the crisis were 34 percent higher than the actual losses reported ten years later.
- The initial incurred loss estimate for 1988—the apogee of the crisis—has proved to be 37 percent overstated.
- In total, for the 7 years 1986 through 1992, malpractice insurers' initial incurred loss estimates were $16.8 billion; they reported incurred losses of $11.6 billion for those years 10 years after the initial estimates, for a total overstatement of $5.2 billion, or 31 percent.
- Initial incurred loss estimates for "occurrence coverage" policies for the years 1986–92 totaled $12.9 billion, but the reported incurred losses for these years was corrected to $8.3 billion ten years later, a total overstatement of $4.6 billion, or 35 percent.

The graph below illustrates the change in the combined (occurrence and claims-made policies) incurred losses, as reported by the Nation's medical malpractice. providers over the course of ten years. The graph shows that the losses insurers initially reported are far higher than the restated losses that are reported ten years later. Even after revising the original 1988 projections upward in 1989, that year's losses, along with every year's losses, eventually fell precipitously as the incurred loss estimates were refined over time.



The data indicate that medical malpractice insurers overstated their anticipated losses for each of the years analyzed for this study. Additionally, it appears that the losses reported during the insurance crisis of the mid-to late-1980s were more inflated than those of the mid-1990s—although fewer years of restated loss data are available for the mid-1990s.

According to the data (claims made and occurrence policies combined):

- In 1989, medical malpractice insurers announced losses for that year of $4.4 billion; by 1998, that number had been revised downward to $2.7 billion in losses.
- For the years 1986 through 1990, insurers' initial incurred loss estimates were overstated by an average of 36 percent.
- During the following four years (1991–1994), initial incurred loss estimates appear to have been overstated by 24 percent.[22]

C. Reported Losses and the Present Crisis

The current crisis is roughly two years old; there is no data to assess the accuracy of the insurers "incurred loss" reports for recent years. In contrast to the previous years' data, because we have fewer than five years of restated incurred loss estimates for each year beginning with 1997, we cannot yet know what the ultimate payouts will be for claims incurred in those years with any reasonable degree of accuracy.

We can, however, examine the recent incurred loss reports to determine whether the insurers have reported a sudden spike in incurred losses, following the pattern of the 1980s crisis.

As revealed in the table below, there is a noteworthy and sudden increase in reported incurred losses between 2000 and 2001, the beginning of the current crisis. After four years during which total malpractice incurred losses hovered between $5.09 to $5.27 billion, the estimate for 2001 jumped 17 percent to nearly $6 billion.

Initial Incurred Loss Estimate Past Five Years Medical Malpractice

(Claims Made and Occurrence Policies Combined)

Year	Insurers' initial estimates of incurred losses for year
1997	$5,273,973,000
1998	$5,217,410,000

[22] For 1991 and 1992, ten years of incurred loss estimates are available; for 1993, only nine years are available, and for 1993, only eight years are available.

Initial Incurred Loss Estimate Past Five Years Medical Malpractice—Continued

(Claims Made and Occurrence Policies Combined)

Year	Insurers' initial estimates of incurred losses for year
1999	$5,093,117,000
2000	$5,116,965,000
2001	$5,985,382,000

Loss inflation during the last insurance crisis—when insurers had multiple motives to show greater losses—was pronounced compared to the years which immediately followed. That said, for those non-crisis years in which at least five but less than 10 years of claims information is now available, insurers' initial incurred loss estimates also appear to be substantially overstated.

As noted, insurance companies have a financial incentive to overstate losses during periods when their investments are performing poorly. By contrast, in periods of economic growth, such as the mid-1990s, insurers seek to maximize their investment income during such periods by lowering prices in order to attract capital and to expand market share. They have nothing to gain by overstating losses at such times; indeed, inflating losses would reduce insurers' authority under state laws to write additional policies.

In view of this data, it is to be expected that insurers' incurred loss estimates for 2001, 2002 and 2003—and thus their proposed rates for coming years—are inaccurate. We have clear evidence that the malpractice rates insurers charged during the last insurance crisis and the years following it were grossly excessive—by an average of between 31 percent (for claims-made coverage) and 35 percent (for occurrence coverage). We should not be surprised to discover in the future that the incurred loss estimates medical malpractice insurers are reporting today, and the resultant rates that companies are charging, have been similarly inflated.

These results should raise a red flag for insurance regulators and lawmakers. The information presented here suggests that the industry's accounting practices are in need of revision, including far greater scrutiny by insurance and financial regulators.

V. Limiting Liability and Restricting Consumer Rights Does Not Reduce Rates But Does Reduce the Quality of the Insurance Product

The insurance industry, in every state legislature and in Congress, proposes restricting the rights of policyholders or those injured by policyholders as the best way to restrain rates. Rather than regulate insurance companies' actuarial practices, administrative costs and profits, the insurance industry typically calls on government to regulate the ability of consumers to be compensated for an injury. The failure of these proposals is borne out in the data that clearly shows that there is no correlation between rates and legal liability.

The fallacy of the efficacy of tort restrictions lies in the belief that insurers will automatically reduce rates if they are relieved of liability. In fact, without the requirements of regulation, insurers do not and will not reduce rates regardless of whether or not the law limits the rights of policyholders or other claimants.

A. Limits on Third Party Bad Faith Lawsuits Does Not Reduce Insurance Rates

A 1999 study by FTCR found that states that ban injured victims of auto accidents to sue the driver's insurance companies for low-balling or unfairly denying or delaying claims payments actually have faced greater rate increases than states that allow the suits, known as third party bad faith suits. The data directly contradict the insurance industry assertion that banning a third party bad faith cause of action will lower rates.

The insurance industry has suggested that limiting the right to sue brings premiums down and that the converse is also true: allowing such suits raises premiums. Data from the National Association of Insurance Commissioners, however, shows no relationship between the right of third parties to sue and premium levels. According to the study, which reviewed premiums from 1989–1996, California was the only state with a ban on third party suits that saw a reduction in premiums and, other than Pennsylvania, consumers in all states with these tort restrictions saw rate increases of more than 25 percent, with most states above the national average of 35.8 percent for this time period. Of course, California was the only state with the regulatory structure of Proposition 103 in place to restrain rates.

According to the data, a limitation on third party bad faith liability has not resulted in lower premiums as insurers promise. A copy of this study is available at *http://www.consumerwatchdog.org/insurance/rp/rp000156.pdf.*

B. Medical Malpractice Caps Do Not Reduce Insurance Rates

A March 2003 report by FTCR compared the impact on premiums of the tort restrictions of California's Medical injury Compensation Reform Act of 1975 (MICRA) with the regulatory strictures of Proposition 103. The study found that physicians' premiums increased by 450 percent over the first 13 years with the malpractice caps contained in MICRA and declined after the passage of Proposition 103. A copy of that study is available at *http://www.consumerwatchdog.org/healthcare/rp/rp003103.pdf.*

Despite the allegation that caps will lower rates, the reality is that even under California's MICRA law insurers have sought major increases in recent years. A major malpractice insurer, SCPIE, has increased rates by 23 percent since 1999 and the state's largest medical malpractice insurer, NORCAL Mutual, has increased rates by 26 percent since 2001. Indeed, during the aforementioned Proposition 103 rate challenge, SCPIE stated that California's strict malpractice caps law did not hold down insurance rates. In written testimony, SCPIE's actuary and Assistant Vice President James Robertson stated:

> "While MICRA was the legislature's attempt at remedying the medical malpractice crisis in California in 1975, it did not substantially reduce the relative risk of medical malpractice insurance in California."

This is not dissimilar to filings by Aetna and St. Paul Companies in the mid-1980s in which the companies refused to lower rates in Florida after that state imposed a liability cap. According to St. Paul Fire & Marine Insurance Company's 1987 filing with the Florida Department of Insurance:

> "The conclusion of the study is that the noneconomic cap of $450,000, joint and several liability on the noneconomic damages, and mandatory structured settlements on losses above $250,000 will produce little or no savings to the tort system as it pertains to medical malpractice."

In short, liability caps reduce an insurers exposure without any mandatory impact on rates, while insurance regulation necessarily impacts rates as it is, by definition, a mechanism for controlling rates.

C. Regulating Rates Not Rights Makes the Difference

Throughout the country, lawmakers have experimented with a host of liability-limiting tools ostensibly imposed to keep rates down. These restrictions, which include the approaches discussed above, as well as no-fault insurance and a variety of others such as periodic payments and elimination of the collateral source rule, fail to restrain rates because they do not address rates. The flaw in the promise of tort restrictions is that it depends upon insurers to reduce rates without requiring the companies to do so. It should be noted that a more important flaw in these programs is the injustice of barring a victim from access to their rights to compensation for their injuries.

The insurance industry presses for tort restrictions with the promise that rates will go down, but the industry never agrees to mandatory rate decreases and regulatory oversight of the companies. The insurance industry has invested millions of dollars to promote the notion that lawsuits are the sole barrier to affordable insurance, yet after the industry successfully shields itself from lawsuits, there is no commensurate rate decrease.

The lesson from decades of legislation restricting victims' and consumers' rights is that the insurance crises keep happening and rates continue to cycle higher and higher unless lawmakers address the real problem by regulating rates.

VI. Conclusion

In this testimony we have presented the view that the preeminent public interest in protecting insurance consumers requires that insurance rates and practices are subject to a strong and thorough regulatory regime that promotes accountability.

- First and foremost, insurance companies should be subject to strict prior approval system of rate regulation to ensure that consumers neither pay excessive premiums nor shoulder the unmitigated swings of the insurance cycle. Insurers should be required to justify rates and products (demonstrating, for example, the quality of the coverage to be offered) in advance of placing insurance products in the marketplace. As part of the regulatory process, insurers' books should be subject to an additional layer of regulatory accountability by giving

the public an independent right to challenge rate hike proposals and other regulatory actions.

- Insurance companies, which are currently exempt from antitrust laws, are able to collude through the sharing of data in a manner that leaves consumers without a competitive market for insurance products. The industry should be stripped of this unique exemption from the Nation's laws against anticompetitive practices.
- Insurance companies use loss projection techniques that are demonstrably inaccurate and possibly intended to inflate companies' apparent losses. These projections, at least for the medical malpractice line of insurance, are consistently higher than the actual losses insurers pay out over time and should be viewed skeptically by insurance regulators. Similarly the data should not be accepted as grounds for changing tort laws.
- The insurance industry alternative to rate regulation, dubbed "tort reform" by insurers, has not achieved its promised goal of reducing insurance rates. Statutory changes that have limited the legal rights of policyholders and insurance claimants over the past thirty years have consistently failed to produce savings specifically because these laws never limit the rates insurers can charge.

Although the insurance industry will argue for deregulation, much in the same way private energy companies argue for deregulation, the path of strict rate regulation and market conduct enforcement will provide the most security in the most fair and public manner for consumers and insurers. As with energy deregulation, in which many of the major firms either filed for bankruptcy or fell to penny-stock status in the wake of deregulation, a move to further undermine or overturn the insurance regulatory regime would be at the peril of consumers and the insurers.

The model for reforming the insurance industry is California's voter-approved ballot initiative Proposition 103. The initiative has produced a stable and competitive insurance market for fifteen years in California, with above average profits for insurers and below average premiums for consumers.

APPENDIX A

Complete Text of Proposition 103

I. Complete Text Of Proposition 103 As Approved By The California Electors, November 8, 1988

Insurance Rate Reduction and Reform Act

Section 1. Findings and Declaration.

The People of California find and declare as follows:

Enormous increases in the cost of insurance have made it both unaffordable and unavailable to millions of Californians.

The existing laws inadequately protect consumers and allow insurance companies to charge excessive, unjustified and arbitrary rates.

Therefore, the People of California declare that insurance reform is necessary. First, property-casualty insurance rates shall be immediately rolled back to what they were on November 8, 1987, and reduced no less than an additional 20 percent. Second, automobile insurance rates shall be determined primarily by a driver's safety record and mileage driven. Third, insurance rates shall be maintained at fair levels by requiring insurers to justify all future increases. Finally, the state Insurance Commissioner shall be elected. Insurance companies shall pay a fee to cover the costs of administering these new laws so that this reform will cost taxpayers nothing.

Section 2. Purpose.

The purpose of this chapter is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians.

Section 3. Reduction and Control of Insurance Rates.

Article 10, commencing with Section 1861.01 is added to Chapter 9 of Part 2 of Division 1 of the Insurance Code to read:

Insurance Rate Rollback

1861.01.(a) For any coverage for a policy for automobile and any other form of insurance subject to this chapter issued or renewed on or after November 8, 1988, every insurer shall reduce its charges to levels which are at least 20 percent less than the charges for the same coverage which were in effect on November 8, 1987.

(b) Between November 8, 1988, and November 8, 1989, rates and premiums reduced pursuant to subdivision (a) may be only increased if the commissioner finds, after a hearing, that an insurer is substantially threatened with insolvency.

(c) Commencing November 8, 1989, insurance rates subject to this chapter must be approved by the commissioner prior to their use.

(d) For those who apply for an automobile insurance policy for the first time on or after November 8, 1988, the rate shall be 20 percent less than the rate which was in effect on November 8, 1987, for similarly situated risks.

(e) Any separate affiliate of an insurer, established on or after November 8, 1987, shall be subject to the provisions of this section and shall reduce its charges to levels which are at least 20 percent less than the insurer's charges in effect on that date.

Automobile Rates & Good Driver Discount Plan

1861.02. (a) Rates and premiums for an automobile insurance policy, as described in subdivision (a) of Section 660, shall be determined by application of the following factors in decreasing order of importance:

(1) The insured's driving safety record.

(2) The number of miles he or she drives annually.

(3) The number of years of driving experience the insured has had.

(4) Such other factors as the commissioner may adopt by regulation that have a substantial relationship to the risk of loss. The regulations shall set forth the respective weight to be given each factor in determining automobile rates and premiums. Notwithstanding any other provision of law, the use of any criterion without such approval shall constitute unfair discrimination.

(b)(1) Every person who (A) has been licensed to drive a motor vehicle for the previous three years and (B) has had, during that period, not more than one conviction for a moving violation which has not eventually been dismissed shall be qualified to purchase a Good Driver Discount policy from the insurer of his or her choice. An insurer shall not refuse to offer and sell a Good Driver Discount policy to any person who meets the standards of this subdivision. (2) The rate charged for a Good Driver Discount policy shall comply with subdivision (a) and shall be at least 20 percent below the rate the insured would otherwise have been charged for the same coverage. Rates for Good Driver Discount policies shall be approved pursuant to this article.

(c) The absence of prior automobile insurance coverage, in and of itself, shall not be a criterion for determining eligibility for a Good Driver Discount policy, or generally for automobile rates, premiums, or insurability.

(d) This section shall become operative on November 8, 1989. The commissioner shall adopt regulations implementing this section and insurers may submit applications pursuant to this article which comply with such regulations prior to that date, provided that no such application shall be approved prior to that date.

Prohibition on Unfair Insurance Practices

1861.03 (a) The business of insurance shall be subject to the laws of California applicable to any other business, including, but not limited to, the Unruh Civil Rights Act (Civil Code Sections 51 through 53), and the antitrust and unfair business practices laws (Parts 2 and 3, commencing with section 16600 of Division 7, of the Business and Professions Code).

(b) Nothing in this section shall be construed to prohibit (1) any agreement to collect, compile and disseminate historical data on paid claims or reserves for reported claims, provided such data is contemporaneously transmitted to the commissioner, or (2) participation in any joint arrangement established by statute or the commissioner to assure availability of insurance.

(c) Notwithstanding any other provision of law, a notice of cancellation or nonrenewal of a policy for automobile insurance shall be effective only if it is based on one or more of the following reasons: (1) non-payment of premium; (2) fraud or material misrepresentation affecting the policy or insured; (3) a substantial increase in the hazard insured against.

Full Disclosure of Insurance Information

1861.04. (a) Upon request, and for a reasonable fee to cover costs, the commissioner shall provide consumers with a comparison of the rate in effect for each personal line of insurance for every insurer.

Approval of Insurance Rates

1861.05. (a) No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income.

(b) Every insurer which desires to change any rate shall file a complete rate application with the commissioner. A complete rate application shall include all data referred to in Sections 1857.7, 1857.9, 1857.15, and 1864 and such other information as the commissioner may require. The applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of this article.

(c) The commissioner shall notify the public of any application by an insurer for a rate change. The application shall be deemed approved sixty days after public notice unless (1) a consumer or his or her representative requests a hearing within forty-five days of public notice and the commissioner grants the hearing, or determines not to grant the hearing and issues written findings in support of that decision, or (2) the commissioner on his or her own motion determines to hold a hearing, or (3) the proposed rate adjustment exceeds 7 percent of the then applicable rate for personal lines or 15 percent for commercial lines, in which case the commissioner must hold a hearing upon a timely request.

1861.06. Public notice required by this article shall be made through distribution to the news media and to any member of the public who requests placement on a mailing list for that purpose.

1861.07. All information provided to the commissioner pursuant to this article shall be available for public inspection, and the provisions of Section 6254(d) of the Government Code and Section 1857.9 of the Insurance Code shall not apply thereto.

1861.08. Hearings shall be conducted pursuant to Sections 11500 through 11528 of the Government Code, except that: (a) hearings shall be conducted by administrative law judges for purposes of Sections 11512 and 11517, chosen under Section 11502 or appointed by the commissioner; (b) hearings are commenced by a filing of a Notice in lieu of Sections 11503 and 11504; (c) the commissioner shall adopt, amend or reject a decision only under Section 11517 (c) and (e) and solely on the basis of the record; (d) Section 11513.5 shall apply to the commissioner; (e) discovery shall be liberally construed and disputes determined by the administrative law judge.

1861.09. Judicial review shall be in accordance with Section 1858.6. For purposes of judicial review, a decision to hold a hearing is not a final order or decision; however, a decision not to hold a hearing is final.

Consumer Participation

1861.10. (a) Any person may initiate or intervene in any proceeding permitted or established pursuant to this chapter, challenge any action of the commissioner under this article, and enforce any provision of this article.

(b) The commissioner or a court shall award reasonable advocacy and witness fees and expenses to any person who demonstrates that (1) the person represents the interests of consumers, and, (2) that he or she has made a substantial contribution to the adoption of any order, regulation or decision by the commissioner or a court. Where such advocacy occurs in response to a rate application, the award shall be paid by the applicant.

(c)(1) The commissioner shall require every insurer to enclose notices in every policy or renewal premium bill informing policyholders of the opportunity to join an independent, non-profit corporation which shall advocate the interests of insurance consumers in any forum. This organization shall be established by an interim board of public members designated by the commissioner and operated by individuals who are democratically elected from its membership. The corporation shall proportionately reimburse insurers for any additional costs incurred by insertion of the enclosure, except no postage shall be charged for any enclosure weighing less than 1/3 of an ounce. (2) The commissioner shall by regulation determine the content of the enclosures and other procedures necessary for implementation of this provision. The legislature shall make no appropriation for this subdivision.

Emergency Authority
1861.11. In the event that the commissioner finds that (a) insurers have substantially withdrawn from any insurance market covered by this article, including insurance described by Section 660, and (b) a market assistance plan would not be sufficient to make insurance available, the commissioner shall establish a joint underwriting authority in the manner set forth by Section 11891, without the prior creation of a market assistance plan.

Group Insurance Plans
1861.12. Any insurer may issue any insurance coverage on a group plan, without restriction as to the purpose of the group, occupation or type of group. Group insurance rates shall not be considered to be unfairly discriminatory, if they are averaged broadly among persons insured under the group plan.

Application
1861.13. This article shall apply to all insurance on risks or on operations in this state, except those listed in Section 1851.

Enforcement & Penalties
1861.14. Violations of this article shall be subject to the penalties set forth in Section 1859.1. In addition to the other penalties provided in this chapter, the commissioner may suspend or revoke, in whole or in part, the certificate of authority of any insurer which fails to comply with the provisions of this article.

Section 4. Elected Commissioner

Section 12900 is added to the Insurance Code to read:

(a) The commissioner shall be elected by the People in the same time, place and manner and for the same term as the Governor.

Section 5. Insurance Company Filing Fees

Section 12979 is added to the Insurance Code to read:

Notwithstanding the provisions of Section 12978, the commissioner shall establish a schedule of filing fees to be paid by insurers to cover any administrative or operational costs arising from the provisions of Article 10 (commencing with Section 1861.01) of Chapter 9 of Part 2 of Division 1.

Section 6. Transitional Adjustment of Gross Premiums Tax

Section 12202.1 is added to the Revenue & Taxation Code to read:
Notwithstanding the rate specified by Section 12202, the gross premiums tax rate paid by insurers for any premiums collected between November 8, 1988 and January 1, 1991 shall be adjusted by the Board of Equalization in January of each year so that the gross premium tax revenues collected for each prior calendar year shall be sufficient to compensate for changes in such revenues, if any, including changes in anticipated revenues, arising from this act. In calculating the necessary adjustment, the Board of Equalization shall consider the growth in premiums in the most recent three year period, and the impact of general economic factors including, but not limited to, the inflation and interest rates.

Section 7. Repeal of Existing Law

Sections 1643, 1850, 1850.1, 1850.2, 1850.3, 1852, 1853, 1853.6, 1853.7, 1857.5, 12900, Article 3 (commencing with Section 1854) of Chapter 9 of Part 2 of Division 1, and Article 5 (commencing with Section 750) of Chapter 1 of Part 2 of Division 1, of the Insurance Code are repealed.

Section 8. Technical Matters

(a) This act shall be liberally construed and applied in order to fully promote its underlying purposes.

(b) The provisions of this act shall not be amended by the Legislature except to further its purposes by a statute passed in each house by roll call vote entered in the journal, two-thirds of the membership concurring, or by a statute that becomes effective only when approved by the electorate.

(c) If any provision of this act or the application thereof to any person or circumstances is held invalid, that invalidity shall not affect other provisions or applications of the act which can be given effect without the invalid provision or application, and to this end the provisions of this act are severable.

Senator SUNUNU. Thank you, Mr. Heller.

Mr. Rahn?

STATEMENT OF STEPHEN E. RAHN, VICE PRESIDENT, ASSOCIATE GENERAL COUNSEL, AND DIRECTOR OF STATE RELATIONS, LINCOLN NATIONAL LIFE INSURANCE COMPANY, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS

Mr. RAHN. Thank you, Mr. Chairman, and Members of the Committee.

Much of the testimony this morning has focused on the P&C industry. I'm happy to be here today to testify on behalf of the life insurance industry. By way of background, my name is Steve Rahn. I'm the Director of State Government Relations for the Lincoln National Life Insurance Company. I am here today on behalf of the American Council of Life Insurers.

I have spent my entire career dealing in state legislative and regulatory matters. Prior to joining Lincoln, I worked for the Indiana General Assembly.

Now, if past experience with hearings and other committees is any guide, I think you're very quickly learning and can easily appreciate the fact that the current state-based system of insurance regulation has failed to keep pace as our business and our markets have evolved. There's clear consensus today that the current system is badly broken, and I would point out it's not a difference between a Federal system and a state system. There are already over 50 systems of regulation of insurance under the current state-based system.

And I think it's fair to say that most agree that if substantial improvements are not made, and not made quickly, that it will be extremely difficult for life insurers to remain healthy and competitive, and, most importantly, in turn, to provide for the best products for our consumers at the lowest possible cost.

Now, where the paths of the witnesses have diverged today, and will probably continue to diverge today, is on the best way to accomplish needed reform. State regulators are going to argue that there are, indeed, problems, but that the appropriate solutions can all be found within the existing state-based system of regulation and all that's really needed is more time for the states to act.

Others here have suggested, and will continue to suggest, that the Federal Government should help move the remedial process along by enacting Federal minimum standards that the states could then enforce.

Let me briefly address both of those approaches. As indicated in my written statement, life insurers believe that state regulation will always be an integral part of the insurance regulatory landscape, and it's for that reason that the ACLI and the life insurance industry remains firmly committed to working with the states to improve it.

However, progress has been extremely slow, and there's no realistic expectation that the many aspects of the state system that need to be improved will be addressed within a reasonable period of time. That is why the ACLI has proposed a Federal insurance charter as an option. This would parallel the successful dual-chartering mechanism that we've seen in the banking system.

In terms of geographic scope of the business of life, life insurers are quite similar to banks in that some carriers do business nationally, and some do it internationally, while others operate locally.

We also don't believe that the Federal minimum standards are the answer either, as, by their very nature, they don't provide the uniformity that our industry so desperately needs. Minimum standards establish only a baseline that the states could modify as they see fit. For life insurance, laws and regulations need to be uniform from one jurisdiction to another. We may have life insurance that operates locally, but even they don't have local issues. It's very different than the P&C industry. By that, I mean that life insurance product standards, financial solvency requirements, and consumer protections can and should be uniform throughout the country.

In addition, the Federal minimum standards approach would not create a Federal insurance presence in Washington that we believe is critical for an industry that is increasingly international in scope and plays an enormously important role in the economy. It is simply too critical of a cog in the Nation's financial machinery for the Federal Government not to understand our issues, nor for our industry to remain the only segment of the financial services industry without a primary Federal regulator.

My last point is perhaps the most important. It's imperative that we be successful in modernizing the life insurance regulatory system, because if we aren't and if the life insurance franchise is minimalized—or marginalized, the consequences to consumers and the economy would be devastating.

Consider this. We currently have 76 million baby-boomers nearing retirement. With life expectancies increasing, these retirees will have to depend increasingly upon the products and services that only the life insurance industry can provide. These include products that have guaranteed lifetime payments, long-term care, and lifetime financial security. As you are well aware, Social Security and Medicare alone simply aren't up to the task.

Equally important to consider is the fact that the life insurance industry ranks fourth among institutional sources of funds supplying 9 percent of the total capital in the financial markets, or $3.4 trillion, and we're the principal source of long-term capital.

Mr. Chairman, I again thank you for having this hearing. And while we have some concerns with his bill, I would like to thank Senator Hollings for introducing his Federal optional charter legislation. We're pleased that the Senate is beginning to focus in earnest on the critical question of how to modernize the insurance regulatory system, and we encourage you, in the strongest terms, to work with us to put in place an appropriate Federal charter option for insurance companies. We believe that's in the best interest of the industry, its customers, and our economy.

Thank you.

[The prepared statement of Mr. Rahn follows:]

PREPARED STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURERS GIVEN BY STEPHEN E. RAHN, VICE PRESIDENT, ASSOCIATE GENERAL COUNSEL AND DIRECTOR, STATE RELATIONS, LINCOLN NATIONAL LIFE INSURANCE COMPANY

Mr. Chairman and members of the Committee, my name is Steve Rahn, and I am Vice President, Associate General Counsel and Director of State Relations for The Lincoln National Life Insurance Company. I am appearing today on behalf of the

American Council of Life Insurers, the principal trade association representing domestic life insurance companies. The ACLI's 383 member companies account for over 70 percent of the life insurance premiums and 77 percent of annuity considerations of U.S. life insurance companies. I am also Chairman of the ACLI's Policy Advisory Group, which has spearheaded the association's efforts to develop a Federal legislative solution to the issue of regulatory modernization.

I appreciate the opportunity to appear before you today to discuss the pressing need to modernize the life insurance regulatory framework. In survey after survey of the ACLI membership, including one this summer of life insurer CEOs serving on the ACLI Board of Directors, regulatory modernization is the very top priority of our business.

My message to you this morning is both simple and urgent. The life insurance business is a vital component of the U.S. economy, providing a wide array of essential financial and retirement security products and services to all segments of the American public. However, for the insurance business to remain viable and serve the needs of its customers effectively, our system of life insurance regulation must become far more efficient and be brought in line with the needs and circumstances of today's marketplace. This is not a call for less regulation. It is a call for strong regulation administered efficiently, preserving the paramount importance of effective solvency regulation and appropriate consumer protections.

I would like to focus on three points the morning. First, why regulation is so important to us at this juncture. Second, what the ACLI has done to assess the current regulatory environment and identify areas that are in need of improvement. And third, the options for improvement we are focusing on and how we are pursuing them.

The Changing Marketplace and the Importance of Efficient Insurance Regulation

The marketplace environment in which life insurers and other financial intermediaries compete has changed dramatically in the past several years. Importantly, the role of regulation in this new competitive paradigm has increased significantly.

Historically, life insurers competed only against other life insurers. Whatever the inefficiencies of insurance regulation, companies incurred them equally. Existing companies had learned how to cope with the unwieldy regulatory apparatus, and potential new entrants almost always looked to existing companies and charters because of the difficulty of creating a new one. The status quo, while often frustrating, did not present insurers with serious competitive problems.

Today, the situation is radically different. A generation ago, the average life insurer took in almost 90 percent of its premiums from the sale of life insurance, compared to only 13 percent from annuities. Today, those numbers are almost completely reversed, with 70 percent of premium receipts coming from annuities compared to only 30 percent from life insurance products. Today, life insurers administer over $1.8 trillion in retirement plan assets, amounting to over 25 percent of the private retirement plan assets under management in the U.S.

The point is that life insurers, as providers of investment and retirement security products, find themselves in direct competition with brokerages, mutual funds, and commercial banks. These non-insurance firms have far more efficient systems of regulation, often with a single, principal Federal regulator. Without question, the regulatory efficiencies they enjoy translate into very real marketplace advantages. Our system of insurance regulation now stands as perhaps the single largest barrier to our ability to compete effectively.

In the context of this new competitive environment, insurers' inability to bring new products to market in a timely manner is the most serious shortcoming of the current regulatory system. National banks do not need explicit regulatory approval to bring most new products to market on a nationwide basis. Securities firms typically get regulatory approval for new products in several months. By contrast, life insurers must get new products and disclosure statements approved in each state in which the product will be offered, and different jurisdictions often have widely divergent standards, interpretations, and requirements applicable to identical products. Without question there are individual states that are quite prompt in reviewing a company's product form filings. Others are not. And the problem, of course, is getting approval in multiple jurisdictions, which is extremely costly, extremely time consuming, and can take a year or more—and in some instances much longer. With the average shelf life of innovative new life insurance products being approximately two years, it is easy to see why the current product approval process is so problematic.

The advent of Gramm-Leach-Bliley and an increasingly diversified financial services landscape will only intensify concerns in this area. For example, there is clear

evidence that firms having both insurance and securities operations are allocating capital away from the insurance unit due largely to the inefficiency of the insurance regulatory system. New securities products can be brought to market in a more timely and cost-effective manner than their insurance counterparts. Over the long run, the implications to insurers and their customers of these adverse capital allocation decisions are serious, and they can be expected to worsen as consolidation and cross-industry diversification continue.

Even with respect to products such as whole life insurance, which have no direct analog in the banking or securities businesses, we face competition from other providers of financial services for the consumer's attention and disposable income. Moreover, the costs of regulatory inefficiency are necessarily borne directly or indirectly by the public.

The present state-based system of insurance regulation was instituted at a time when "insurance" was not deemed to be interstate commerce. Consequently, the underpinnings of that system—which remain pervasive today—contemplate doing business only within the borders of a single state. Today, most life insurers do business in multiple jurisdictions if not nationally or internationally. And, the system has been cumulative, with new laws, rules and regulations often added but old ones seldom eliminated. In short, our system of regulation has failed to keep pace with changes in the marketplace, and there is a very wide gap between where regulation is and where it should be.

For many life insurers, making regulation more efficient is now an urgent priority. Companies no longer believe they have the luxury of being able to wait for years and years while incremental improvements are debated and slowly implemented on a state-by-state basis.

Importance of the Life Insurance Franchise

Failure to modernize the life insurance regulatory system risks marginalizing the life insurance franchise, and the resulting adverse consequences to consumers and the economy would be substantial. Life insurers are unique in that they are the only institutions capable of guaranteeing against life's uncertainties. Through life insurance, annuities, and other financial protection products, life insurers protect against living too long and not living long enough. With 76 million baby-boomers nearing retirement, there is the potential for a true retirement crises. We not only have an aging population with increasing life expectancies, but must also confront the fact that the average American nearing retirement has only $47,000 in savings and assets, not including real estate. Fully 68 percent of Americans believe they will not be able to save enough for retirement. Over 61 percent are afraid they will outlive their savings. The role of life insurers in addressing the retirement security needs of millions of Americans has never been more important. Retirees will depend increasingly upon the services only life insurance products provide; guaranteed income, long term care, and lifetime financial security. As the Congress faces the Social Security and Medicare challenges in the next fifty years, it will need a high performing life insurance industry to partner with and help shoulder the burden.

Life insurers not only help in shaping how people plan for the future, but also in sustaining long-term investments in the U.S. economy. Fifty-seven percent of the industry's assets—$2 trillion—is held in long-term bonds, mortgages, real estate, and other long-term investments. The industry ranks fourth among institutional sources of funds, supplying 9 percent of the total capital in financial markets, or $3.4 trillion. Investments include: $417 billion in federal, state, and local government bonds, which help fund urban revitalization, public housing, hospitals, schools, airports, roads, and bridges; $251 billion in mortgage loans on real estate-financing for homes, family farms, and offices; $1.2 trillion in long-term U.S. corporate bonds; and $791 billion in corporate stocks. In 2002, life insurers invested more than $304 billion in new net funds in the Nation's economy.

Lack of Uniformity Hampers Multi-State Insurers

A significant impediment for multi-state insurers is the current state-based system's inability to produce, in crucial areas, both uniform standards and consistent application of those standards by the states. I'd like to give you a brief outline of the business and regulatory complexities commonly faced by life insurers under the current system.

Before a company can conduct any activities, it must apply for a license from its "home" or "domestic" state insurance department. A license will be granted if the company meets the domestic state's legal requirements, including capitalization, investment and other financial requirements, for acting as a life insurer. If the company wishes to do business only in its home state, this one license will be sufficient. However, in order to sell products on a multi-state basis, a company must apply for

licenses in all the other states in which it seeks to do business. Each additional state may have licensing requirements that deviate from those of the company's home state, and the company will have to comply with all those different requirements notwithstanding the fact that the home state regulator will remain primarily responsible for the insurer's financial oversight.

Once a company has all its state licenses, it can turn its attention to selling policies. To do that, a company must first file each product it wishes to market in a particular state with that state's insurance department for prior approval. A company doing business in all states and the District of Columbia must, for example, file the same policy form 51 different times and wait for 51 different approvals before selling that product in each jurisdiction. And this process must be repeated for each product the insurer wishes to offer. Since these 51 different insurance departments have no uniform standards for the products themselves or for the timeliness of response for filings, a company may receive approval from one or two jurisdictions in 3 months, from another ten jurisdictions in 6 months, and may have to wait 18 months or longer to receive approval from all jurisdictions.

This process is further complicated by the fact that each insurance department may have its own unique "interpretation" of state statutes, even those that are identical to the statues in other jurisdictions. As a result, a company will be required to "tweak" its products in order to comply with each individual department's "interpretation" of what otherwise appeared to be identical law. Since a company has to refile each product after it has been "tweaked," the time lapse from original filing to final approval can very well be double that which was originally expected. And, as a result of the various "tweaks," what started out as a single product may wind up as thirty or more different products.

After a company has received approval to sell its products in a state, it needs a sales force to market those products. Here again we encounter the inefficiencies of the current state system. Each state requires that anyone wishing to act as an insurance agent first be licensed as such under the laws of that state. Each state has its own criteria for granting an agent's license, and this criteria includes differing continuing education requirements once the license is issued. Like companies, insurance agents wishing to work with clients in more than one state must be separately licensed by the insurance departments in each of those states. And, because of the differing state form filing requirements for companies noted above which results in products being "tweaked" for approval in each of the various jurisdictions, persons granted agent licenses by more than one state will not always have the ability to offer all clients the same products.

After this multitude of licenses and approvals has been secured, a company can begin to sell products nationwide. However, the lack of uniformity in standards and application of laws will continue to be a complicated and costly regulatory burden that the company must constantly manage. The very basic things that any business must do to be successful—such as employing an advertising campaign, providing systems support, maintaining existing products, introducing new products and keeping our sales force educated and updated—are all affected 51 different sets of laws, rules and procedures under the current regulatory structure.

Add to this the fact that states also police actual marketplace activity by subjecting a company to market conduct examinations by the insurance departments of every state in which it is licensed. Even though state market conduct laws nationwide are based on the same NAIC model laws, there is minimal coordination on these exams among the various states. As a result, a company licensed to do business in all 51 jurisdictions is perpetually having states initiate market conduct examinations just as one or more other states are completing theirs, with the cost of each exam being borne by the company. And, because these examinations are largely redundant, the benefits derived relative to the costs incurred are marginal at best.

In sum, these issues result in very real costs in terms of money, time, labor and lost business opportunities attributable to this cumbersome state regulatory system, which places a great competitive burden on individual companies, and on the industry as a whole.

ACLI Study of Insurance Regulation

By the late 1990s, life insurers had concluded that it was imperative for the industry to address the issue of regulatory reform. In September of 1998, the ACLI Board of Directors instructed the association to undertake a detailed study of life insurance regulation. The objective of this study was to pinpoint those aspects of regulation that are working well and those aspects that are hindering life insurers' ability to compete effectively and thus in need of improvement. This study broke life insurance regulation down into 35 individual elements (*e.g.,* agent and company li-

censing, policy/contract form approval, solvency monitoring, guaranty associations, nonforfeiture). Individual elements were then rated based on eight factors (uniformity, speed/timing, cost, objective achieved, necessity/relevance, expertise/capacity, sensitivity to industry needs/views, and enforcement/penalties) and assigned one of four overall "scores" based on the eight factors. The overall scores were excellent, good, needs improvement, and unsatisfactory.

This study was completed in November of 1999 and revealed widespread dissatisfaction with the current regulatory system. No element of regulation was rated "excellent," 14 elements were rated "good," and 21 of the 35 elements received negative scores, with 16 rated "needs improvement" and five rated "unsatisfactory."

The study concluded that life insurers generally believe the laws and regulations on the books are necessary and appropriate. However, these laws are seldom uniform across all states and, even where uniform, are frequently subject to divergent applications and interpretations. Having to comply with even uniform laws 50+ times is costly and time consuming. When those laws differ and when interpretations of identical or similar laws differ significantly state-to-state, an insurer's ability to do business in multiple jurisdictions is severely hindered. Given these considerations, the life insurers do not seek diminished regulation. Rather, they seek a far more efficient means of administering the laws and regulations to which they are now subject.

A copy of the ACLI report, entitled *"Regulatory Efficiency and Modernization: An Assessment of Current State & Federal Regulation of Life Insurance Companies and an Analysis of Options for Improvement,"* is being made available separately to provide additional background on this issue.

Solutions

Pursuant to a policy position adopted by our Board of Directors and embraced by our membership, the ACLI is addressing regulatory reform on two tracks. Under the first track, the ACLI is working with the states to improve the state-based system of insurance regulation. Under the second, the ACLI has developed draft legislation providing for an optional Federal charter for life insurers.

Improvements to State Regulation

Improving a state-based system of regulation has never really been an "option" for the ACLI: rather, it is a given. While substantial changes to the present system must be made, regulation of insurance by the states will always be a fundamental part of our regulatory environment. From the ACLI's perspective, the yardstick for gauging the success of regulatory reform in the principal areas where change is necessary is quite simple: uniform standards; consistent interpretations of those standards; and a single point of contact for dealing with multiple jurisdictions. Only in this way will insurers doing a national business be able to operate effectively and provide their customers with the products and services they are demanding.

The states and the leadership of the National Association of Insurance Commissioners (NAIC) deserve credit for the way in which they have stepped up to the task of developing strategies for implementing meaningful reform. The states are working to forge a strong consensus for progressive change. While the true measure of success, of course, will be the actual implementation of appropriate reforms, the NAIC has shown strong commitment and effort over the course of the last several years.

Optional Federal Charter

At the same time the ACLI Board reaffirmed its commitment to improve state regulation, it also directed the association to aggressively pursue an optional Federal charter for life insurance companies. This decision reflects several different perspectives within our membership. A number of companies believe the insurance business is badly in need of a dual regulatory system analogous to that presently found in the commercial banking, thrift, and credit union businesses. Such a system enables institutions to select a state or Federal charter based on the particular needs and circumstances of their operations. For example, companies doing business in multiple jurisdictions might be more inclined to opt for a Federal charter so that they will have to deal with only a single regulator. On the other hand, companies doing business in a single state might find a state charter to be far more practical and cost-effective. Other companies are skeptical that at the end of the day individual state regulators and state legislators will be able to cede authority to the extent necessary to implement a system of uniform, efficient state regulation.

Additionally, most life insurers are increasingly convinced that there is a need for a Federal insurance regulatory "presence" in Washington. More than at any other time in our history, issues dramatically affecting our business are being debated and decided in Congress. Yet, unlike any other segment of the financial services indus-

try, there is no regulator in Washington that can serve as a source of information and perspective for lawmakers. This lack of insurance regulatory presence was illustrated dramatically in the wake of the events of 9/11/01 when lawmakers had no ready source of information and advice on the immediate and longer-term insurance consequences of those events.

The ACLI spent approximately a year and a half developing draft legislation providing an optional Federal charter for life insurers. This effort involved over 300 ACLI member company representatives and brought to bear their considerable expertise on literally every aspect of life insurance regulation. The American Insurance Association and the American Bankers Insurance Association also developed draft optional Federal charter legislation. These groups have worked closely over the last year and have reached agreement on a consensus draft of a bill providing for a Federal charter option for all lines of insurance, insurance agencies and insurance agents.

Congress Should Avoid Incremental Federal Legislation

There have been suggestions that Congress should defer action on optional Federal insurance charter legislation and instead see whether an incremental approach to regulatory efficiency might suffice. For example, discrete issues such as product approvals or coordination of market conduct examinations might be addressed along the lines of the NARAB provisions included as part of the Gramm-Leach-Bliley Act.

Quite candidly, Mr. Chairman, I would argue strongly against this approach for a number of reasons. First, the effort of the states and the NAIC to enhance regulatory efficiency is, by its very nature, incremental. The states have identified several priority issues to tackle, and they are developing concepts to deal with them. Achieving some form of overall "national treatment" under a state regulatory regime should be an ultimate goal, but even the states have recognized that it is impractical to seek to achieve that goal in the near term. We simply do not need the states *and* the Congress employing incremental approaches to regulatory modernization.

As noted above, ACLI is working aggressively with the states and the NAIC to improve state-based regulation. While we salute the NAIC and others for their efforts toward this end, the ACLI believes this effort should not be exclusive of but rather complementary to the pursuit of an optional Federal charter.

One of the fundamental values of a Federal charter option is that it can achieve uniformity of insurance laws, regulations and interpretations the moment it is put in place. And only Congress can enact legislation that has this broad-based, immediate effect. As I noted at the outset, many life insurers believe regulatory modernization is a survival issue, and in that context the speed with which progressive change takes place is critical. Today's marketplace is intolerant of inefficient competition. And the prospect of having to wait a number of years to see whether incremental Federal legislation will even be enacted, and then, if it is, having to wait for some additional period of time to see whether it works is not even remotely appealing to me. Because if the answer turns out to be "no," my company will likely have become irrelevant long before any meaningful steps have been taken. We are not willing to take that risk.

In my judgment, Congress should not "finesse" this issue by putting a clock on the states either to force them to perform better or to see how much they can accomplish over some set period of time. This approach ultimately sidesteps the responsibility to protect a vital industry and the consumers it serves.

I believe Congress should focus its attention on a global, comprehensive alternative to state insurance regulation expressly crafted to meet the needs of today's national and multinational insurers. I believe an immediate and concerted effort to put in place an optional Federal charter is the best course of action for providing needed regulatory solutions for our industry and for providing the states with strong incentive for improving their regulatory structure.

In sum, the ACLI will work with the states to pursue important but incremental improvements to state insurance regulation. But we will look to Congress for the improvements that only Congress can provide in the form of an optional Federal insurance charter.

An Optional Federal Charter Is Not an Attack on States' Rights

Insurance is the only segment of the U.S. financial services industry that does not have a significant Federal regulatory component. Under the optional Federal charter concept being advanced by the ACLI and others, the states would retain a greater, or at least as significant, a role in insurance regulation as their state regulatory counterparts now have in the banking and securities industries.

The Federal charter proposal does not mandate Federal insurance regulation of all insurers. Rather, it allows an insurance company the *option* of seeking a Federal

charter if company leadership believes that to be more complementary to the company's structure, operations or strategic plan.

It is not an affront to states' rights to seek the elimination of conflicting or inconsistent laws. A principal objective of the ACLI proposal is to reduce the regulatory burden caused by such conflicts and redundancies and to do so by adopting the best state laws and regulations as the applicable Federal standards.

A further objective of the Federal charter option is to modernize the insurance regulatory framework and, in so doing, make insurers significantly more competitive in the national and global marketplace. Enhancing competition is a sound and legitimate role for Congress and substantially outweighs concerns over any diminution of the regulatory role of the states.

The importance of insurance protection was underscored by the events of September 11, as was the fact that it is in the national interest to have a Federal authority with expertise and involvement in the U.S. insurance industry given the industry's significant and substantial importance to the overall financial health of the Nation. Establishing an agency to fill this void is not, and should not be characterized as, a diminution of states' rights.

Finally, the concept of an optional Federal charter is far less an infringement on states' rights and prerogatives than preemptive Federal standards, minimum or otherwise. The latter apply to all insurers and suggest that the states are incapable of dealing with important regulatory matters even as they pertain to state chartered carriers.

An Optional Federal Charter Will Not Foster Regulatory Arbitrage

Some have suggested that the implementation of a Federal charter option will lead to regulatory arbitrage and a regulatory "race to the bottom" as companies seek increasingly lax regulation and regulators rush to accommodate. Nothing could be further from the truth.

First and foremost, the ACLI and its member companies are not seeking to migrate to a Federal system of insurance regulation that is lax. To the contrary, we are seeking an strong regulator located in the Treasury Department that will administer a comprehensive system of regulation predicated on the "best-of-the-best" drawn wherever possible from existing state statutes or NAIC model laws. Only where the state system is irreparably broken (*e.g.,* the product approval process) have we sought to create new regulatory concepts.

Second, the notion that adding one more system of regulation on top of the 51 that already exist will somehow give rise to regulatory arbitrage is groundless. Today, companies have the right in virtually all jurisdictions to change their state of domicile—that is, to move to a different state that would have primary responsibility for the company's financial oversight. Consequently, there are 51 opportunities for regulatory arbitrage today.

It is inconceivable that Congress would put in place a Federal regulatory option that was not at least as strong as the better—if not the best—state system. How, then, would we be creating some new opportunity for this dreaded "race-to-the-bottom?" What possible harm would come from companies moving to a Federal system of regulation that is as strong as, if not stronger than, the one they are leaving?

Inherent in this assertion of possible regulatory arbitrage is the notion that a company executive could wake up one morning and simply decide to flip a company's charter. Quite simply, business does not work that way. Such a change carries with it countless significant consequences and considerations and is not entered into lightly. It is costly, time consuming and initially highly disruptive. The notion of regulatory arbitrage implies that companies would be inclined to move into and out of regulatory systems on a whim or whenever decisions were made or likely to me made that would be adverse to their interests. In the real world, this does not and would not occur.

The Federal Charter is Optional

We urge you to keep in mind that all advocates for a Federal insurance charter believe that the charter should be optional. Companies that do a local business or that for other reasons would prefer to remain exclusively regulated by the states are perfectly free to do so. The ACLI has worked hard to draft a Federal charter option that, to the extent reasonably possible, remains "charter neutral." For example, we have avoided building into the Federal option advantages (*e.g.,* tax advantages) that companies would be hard pressed to turn their backs on even if they wished to remain state regulated.

While individual motives may vary, our member life insurance companies are strongly united in our desire to modernize our regulatory system so we can regain our competitive footing and effectively serve our customers. Some feel that a Federal

charter is in the long-term best interest of their company and customers. Others have indicated they would prefer to remain state chartered even if a Federal charter were available to them. Like other financial service firms, we believe insurers must have the ability to select the charter that best suits our operations, products, markets and long-term strategies

An Optional Federal Charter Will Not Disrupt State Premium Tax Revenues

Opponents of an optional Federal charter have suggested that if such an option were to become a reality, national insurers would, over time, somehow escape state premium taxes, which constitute a significant source of revenue for all states. This concern is totally unfounded.

As this Subcommittee knows better than most, with the exception of Government Sponsored Enterprises, all for-profit federally chartered financial institutions such as commercial banks, savings banks and thrifts pay state income taxes. For insurers, this state tax obligation takes the form of a state premium tax. There is no precedent for, nor is there any expectation of, exclusion from this state tax obligation. Indeed, all versions of the optional Federal charter legislation expressly provide for the continuation of the states' authority to tax national insurers.

There is presently debate in some jurisdictions over whether insurers should pay a state net income tax in lieu of a state premium tax. This debate will continue irrespective of whether there is an optional Federal insurance charter. Simply put, state tax revenue is not a material factor in the debate over an optional Federal charter.

Consumer Protections Will Not Diminish Under an Optional Federal Charter

We believe insurance consumers will also benefit if an optional Federal charter becomes a reality. Strong solvency oversight and strong consumer protections are the cornerstones of any effective insurance regulatory system. The ACLI draft optional Federal charter legislation and the consensus version being finalized by the ACLI and other interested groups is built on these cornerstones. In this regard, the draft legislation duplicates the following important aspects of state insurance laws:

- It guarantees that consumers are protected against company insolvencies by extending the current successful state-based guaranty mechanism to national insurers and their policyholders.
- It ensures the financial stability of national insurers by requiring adherence to statutory accounting principles that are more stringent (conservative) than GAAP.
- It duplicates the stringent investment standards currently required under state law.
- It mirrors the strong risk-based capital requirements of state law to ensure companies have adequate liquid assets.
- It duplicates state valuation standards that ensure companies have adequate reserves to pay consumers' claims when they come due.
- It reproduces the requirement that companies submit quarterly financial statements and annual audited financial reports.
- It mirrors the existing nonforfeiture requirements under state law that guaranty all insureds receive minimum benefits under their policies.

In addition, consumers who deal with national insurers may very well enjoy significant added protections and benefits over those afforded by the states. For example, consumers will experience uniform and consistent protections nationwide and will enjoy the same availability of products and services in all 50 states. Consumers will also benefit from uniform rules regarding sales and marketing practices of companies and agents, and for the first time consumer issues of national importance will receive direct attention from a Federal regulator.

Conclusion

Life insurers today operate under a patchwork system of state laws and regulations that is not uniform and that is applied and interpreted differently from state to state. The result is a system characterized by delays and unnecessary expenses that harm companies and disadvantage their customers. Failure to reform insurance regulation will pose a severe and ever larger competitive burden that could threaten the viability of the life insurance industry and those it serves in an increasingly competitive global economy.

Mr. Chairman, we encourage you in the strongest terms to work with us to put in place an appropriate Federal regulatory option available to insurance companies,

insurance agencies, and insurance producers. It is in the best interests of our industry, its customers and our overall economy to do so as expeditiously as possible.

On behalf of the member companies of the American Council of Life Insurers, I would like to conclude by thanking you and members of the Committee for the opportunity to express our views on this most important subject.

Senator SUNUNU. Thank you very much, Mr. Rahn.

I will defer to Senator Hollings for the first round of questions.

Senator HOLLINGS. Thank you very much, Mr. Chairman.

Mr. Rahn, I think, most respectfully, that our bill, patterned after the California system, is not an option bill. Otherwise, trying to go down the roll call here of this outstanding panel, obviously Mr. Heller and Mr. Hunter favor the change or some kind of bill along the lines of 1373. Mr. Rahn wants to get Federal minimum standards reform, as necessary, so a Federal insurance charter option, as does Mr. Berrington. He wants the option charter. The only fellow in favor of staying in the—when in doubt, do nothing, and staying in doubt all the time, is my own Commissioner, Mr. Csiszar.

[Laughter.]

Senator HOLLINGS. I speak affectionately of him, because he was a Canadian when the Governor first went to appoint him, and I had to rush around making him a citizen.

[Laughter.]

Mr. CSISZAR. And I thank you for it.

Senator HOLLINGS. Yes sirree, and we're delighted to have you as a citizen. And, incidentally, the Republican Governor just reappointed him, so both sides have every confidence in him.

Senator SUNUNU. Well, with all due respect, Senator Hollings, I very much appreciate the fact that both of you are from South Carolina, but I think I have an easier time with Mr. Csiszar's accent.

[Laughter.]

Senator HOLLINGS. I do, too.

[Laughter.]

Senator HOLLINGS. Now, having said that, the best testimony, if I were a juror, is Mr. Ahart. And the reason I say that, and I really want to yield to our friend, who was the insurance commissioner and knows way more about it than anybody else, Senator Nelson, because he's been in the pits and done an outstanding job down there in Florida—and, incidentally, Mr. Heller, that was in Florida. The witnesses all appeared back in the 1980s before this Committee, 25 years ago, and they said, "If we had product liability, product liability regulation, that immediately the rates would go down." And you jogged my memory, the State of Florida did do that, adopted a product liability bill, and St. Paul and the others, the rates went up. The rates went up. That's the actual record. I remember that. That's why I'm frustrated, but not with Mr. Ahart.

[Laughter.]

Senator HOLLINGS. I'm not frustrated a bit, because he's the one I worry about. I've had relatives in the insurance business, I've had the agents—I lost a home, and thank goodness for the agent, Mr. McDowell, because the first question is, "Was it a total loss?" They couldn't believe it. They came down and took all the kind of pictures and everything else like that. They realized that I had to

wait for an hour for my house to catch fire from the other houses down the street. Four houses went. And then, of course, the—FEMA grabbed me—I've been after FEMA for years, but they got after me——

[Laughter.]

Senator HOLLINGS.—and raised the level—it's a seashore home, and all of a sudden I couldn't have the third floor, because of the—so I had to reconcile that with the insurance company and other regulations that they had with respect to new construction and everything else of that kind. And with the agent—I'm for the agents—I saw my way through, and we were totally satisfied.

However, you want legislative tools. You want Federal regulation using Federal tools for the file-and-use forms, for the licensing, Federal regulations. There isn't any question, that everybody, except Mr. Csiszar, is for some kind of Federal regulation and fixing of the responsibility and fixing of the understanding and fixing of the responsibility.

Let me go right to the point. Mr. Csiszar, what's wrong with the California bill or my bill, 1373? I'm trying to get criticism. What's wrong with it?

[Laughter.]

Mr. CSISZAR. And criticism you will get, but polite criticism it will be.

Senator HOLLINGS. Surely.

Mr. CSISZAR. As I said, the first concern, of course, is that there is—if you just look at the California market, there is a vast difference in markets between California and a place like South Carolina, for instance. We have had experience in South Carolina with a very strict reapproval process. You might remember John Richards as a commissioner some years ago. And the experience we had with a very, very strict approval process and essentially no rate increases in many instances, was that companies simply left the state. And the end result was that—for instance, in the automobile market, to which I referred earlier, we essentially were left with the South Carolina Reinsurance Facility, State Farm, and Allstate, and no one—there were one or two others, but no one was writing insurance. And as a result, we had the $200 billion—$200 million a year deficits, and, of course, these recoupment fees that you might remember that angered everyone, every driver, particularly the good drivers, who suddenly realized that they were subsidizing the bad drivers through all of this.

So my first response to your bill is that if we were to implement the California-style regulatory system in South Carolina, you'd be driving away the insurance companies, and we have a record of that happening, you know.

Again, I think the fact that there is—that you would have Federal regulation, even though presumably this would entirely preempt, I suppose, any kind of state regulation, as I read your bill, I think you also have to be careful of a number of things, not least of which is that little thing called premium taxes on which states subsist. I think you would endanger that. I think the cost that you might incur with this new system might outstrip the cost of the state system. Even though you're looking at 50 states, Federal regulation, from one estimate that I've seen, consumes about $1.3 tril-

lion a year, with lost opportunities adding another trillion dollars a year, in an $11 trillion kind of economy. So it could be an expensive Federal system that you're implementing this way.

The bureaucracies that go with it, obviously, we've—our record hasn't been good with new kinds of Federal entities. Look at the Energy Department, look at the Education Department. They have become large bureaucracies over the years since we've implemented them.

And, last, I would say that the precedent of Federal supervision isn't necessarily encouraging. We've had long-term capital management, we've had the savings-and-loan crisis, we've had BCCI, which was another bank, we've had, even as recently as a year or two ago, a bank in Chicago, Superior Bank, for instance—I believe it was Superior—going under. So the entire record of Federal supervision isn't all that stellar, I'm afraid.

Senator HOLLINGS. Well, I think you hurt your credibility when you say that 50 state systems would cost less than one Federal system.

But, in any event, you're right, we went into the savings and loan, we cleaned up BCCI. But here, as witnesses say, they need regulation. We've got the GAO report, and everybody says let's get Federal regulation for licensing, file-and-use forms, yes, that it would be an improvement to have the option, at least the option, of a Federal system. They don't talk about a big Federal bureaucracy and everything else of that kind. They're asking, the majority of the witnesses, for Federal regulation and the option.

But, you're right, the automobile insurance market went down in California. And if there's one place where the automobile predominates, that's in state of California, and you and I know what troubles we've had with automobile insurance. When you say it's a different market, ours was lousy, until you came along. You helped clean it up.

But I can tell you right now, the California market has got a stellar record. What's wrong with the California record?

Ms. CSISZAR. My understanding is that the numbers on the California record—and I would defer to some of the associations—but the numbers that I've seen, the price—the lower prices are largely as a result of not having seen any increases in earlier times, as I understand. And in other cases, in other states, you would have those increases. Now, I don't have the numbers at my fingertips, but I do know that that is one of the interpretations that one can take. With respect——

Senator HOLLINGS. Mr. Heller, do you want to comment on that?

Mr. HELLER. Certainly, Senator, if you don't mind. I mean, in a sense that's true. In California, prices weren't increasing, while they were around the nation, but that's because of the regulatory regime. In California, prior to Proposition 103, auto liability rates were the second-highest in the Nation. Now that has declined, and California's rates are lower than the national average, because the commissioner, under Prop 103, ordered the reduction of rates because they were excessive.

Now, in—there have been times when rates have gone up slightly in California because that was appropriate, and that's the key to regulation, and this is why I suggest that Ms. Csiszar has—I

think was off in the point that you don't allow rates—that rates stay frozen. They don't necessarily have to stay frozen; they stay appropriate, and that's what's good for the market. So if there's a need for an increase, the commissioner is obligated to allow it, and that has happened.

In 2000/2001, California auto rates did go up by 3.3 percent, because that's what the market needed, that's what consumers needed, and that's what the industry needed. But you don't see the wild swings, as we've seen recently in medical liability or in homeowners insurance, where rates go up 15, 30 percent at times, because the market is trying to self-regulate and follow the economy.

So, yes, rates went down in California, but they went down because Prop 103 imposed regulation on the system, and it's what was expected.

Senator HOLLINGS. Thank you, Mr. Chairman.

Senator SUNUNU. Thank you, Senator.

Mr. Csiszar, I think it was Mr. Berrington who indicated that there are over 300 different state rate review laws, and he said something over 200 different form review laws. Is that, in fact, the case? And is that really a good and a healthy thing for efficient and competitive markets?

Mr. CSISZAR. Each state, of course, admittedly has its own way of reviewing products and reviewing rates, and it varies by line, so I don't know the exact number that it would be, but certainly the 50 states and the District of Columbia have different regimes, so they vary.

I think the answer, and what we're looking for at the NAIC, is—we understand the need for greater uniformity. There's no question about that. And, in fact, the reforms that we're advocating all move toward that greater uniformity. And I think what we're looking for is a system whereby you have a much greater coordination among the states than we've had in the past, across all areas. And let me give you an example.

When we had the problems in the early 1980s and mid-1980s, one of the systems we came up with was on the financial side, and we came up with an accreditation system. And by virtue of that accreditation system, for instance, now we defer to the domiciliary state in terms of the solvency regime that we have in place.

Now, what I'm suggesting is that there are ways of resolving the costs that you imply if you say you have all these systems. Given that we are trying to bring those into a more uniform, more homogenous state, I would say that, with the accreditation system, for instance, you have an example of how that can be done at the state level. The Federal level is not the only answer, in terms of making it more efficient and making it more effective, if you will. I'm suggesting that the states can do the same thing in a more coordinated manner, whether it be through some accreditation system or another form of coordination.

Senator SUNUNU. Well, there is discussion of the Interstate Compact. I think that's what you're alluding to. It was formally adopted by the NAIC a couple of years ago. How many states have signed onto the compact?

Mr. CSISZAR. I might wish to correct you on the 2 years ago. The adoption really was—it was actually earlier this year. And part of

the reason was, we had agreed on a model, and then the Attorney General has commented on it, consumer groups came back with some comment, so it really wasn't until very recently that we adopted it. Since then, NCOIL and NCSL have both come out in support of that. So the whole process of implementing that compact is really going to occur within the next state legislative session from state to state.

Senator SUNUNU. So you think things are really going to change. It's been a slow, painful——

Mr. CSISZAR. I think——

Senator SUNUNU.—dragged-out process——

Mr. CSISZAR.—I think we can make a change——

Senator SUNUNU.—but things are about to change.

Mr. CSISZAR.—and I—you know, as I said, you know, and I've been criticized for it, but I welcome this kind of opportunity, in a sense, because it does put pressure on us to change. And I don't think that's necessarily bad. But I think that that pressure to change, between that pressure—between that and the willingness of commissioners to set an example, in some instances—for instance, in South Carolina, we've made it much more difficult, by implementing our automobile system, for other states to say that that system can't work. So I think between that, between setting examples, between pressure by the industry, we—it can change, and it will change. And we know there's a limited amount of time. It can't take forever.

Senator SUNUNU. Mr. Hunter, Mr. Csiszar talks about uniformity and the move to uniformity. Do you think uniformity—that movement to uniformity at the state level—is anti-consumer?

Mr. HUNTER. It doesn't have to be. It can be, obviously, if you gut needed regulations. You know, the fact that they have 300 rate approaches is not necessarily surprising, because they have several lines of insurance with different needs, that, if you divide by 50, it's about six rate approaches per state, if that's right. I mean, life insurance has no rate regulation. That's one approach. Some have file-and-use, some—and as I pointed out in my testimony, there is a reason for different rate approaches for different lines of insurance. Some lines of insurance absolutely have to be regulated, because they're anti-competitive lines of insurance, like the assigned risk plan or something like that, where everyone agrees it's not competitive; it has to be regulated. Other lines should not be regulated at all, and then there are degrees in between, depending upon the situation, how informed the consumer is, and so on.

So there are ways to get uniformity within the states, but that doesn't mean there wouldn't still be different approaches to different lines of insurance.

Senator SUNUNU. You also mentioned speed to market in your testimony.

Mr. HUNTER. Yes.

Senator SUNUNU. Do you think efforts to accelerate speed to market is anti-consumer?

Mr. HUNTER. No. In fact, I worked very hard at the NAIC level. When I was a commissioner and after I left as a funded consumer rep at the NAIC, we met almost weekly for a whole year to work out a system of speed to market that would get products and prices

approved within a 30 day timeframe that we agreed to that would eliminate all these funny, odd rules in individual states. We agreed to that. We helped work through all that. Consumers do not want inefficient regulatory systems.

However, when it comes to the point of gutting protections which are going on right now, that's where we say no.

Senator SUNUNU. You suggested that even an optional Federal charter would result in a race to the bottom.

Mr. HUNTER. Yes.

Senator SUNUNU. I think that was the phrase you had used.

Mr. HUNTER. Yes.

Senator SUNUNU. We effectively have an optional Federal chartering system for banks.

Mr. HUNTER. Yes.

Senator SUNUNU. We have state chartered banks, Federal chartered banks.

Mr. HUNTER. Yes.

Senator SUNUNU. Has that resulted in a race to the bottom in the banking industry?

Mr. HUNTER. Yes.

Senator SUNUNU. Would you support—if we repeal the antitrust provisions, antitrust protection, for insurers, either at the state level or by Federal legislation, would you support the elimination of price controls?

Mr. HUNTER. Depends. Depends on the line of insurance and what else is in place. Do you have an informed consumer? Are there systems of consumer information? Is it really a competitive market? You have lines of insurance, like credit insurance, that absolutely have to be regulated——

Senator SUNUNU. Right.

Mr. HUNTER.—regardless of whether there's an antitrust law or not.

Senator SUNUNU. Mr. Ahart, we were just talking about speed to market. Your association has a number of proposals that are out there. Could you maybe speak to the issue of speed to market and how your proposals would improve and affect speed to market?

Mr. AHART. Sure. We would actually have Federal legislation which would be adopted which would preempt state rights. On forms, it would allow file-and-use, and then you'd file the form 30 days prior, the state would have the right to reject it within that 30 days. If it was approved or they've done—they did nothing with it over 30 days, then it would be deemed to be approved, and they'd be able to use it. So that would clearly speed up the issue of forms.

On rates, we would actually look for just the marketplace to take control and just file-and-use without—unless those areas are uncompetitive, and then the state would still regulate them.

Senator SUNUNU. Can you quantify the kind of impact that you think or would hope that this would have on speed to market?

Mr. AHART. I don't know what you mean by quantify, except that all I can say is——

Senator SUNUNU. What's the average speed to market in a given state?

Mr. AHART. Oh, it can take——

Senator SUNUNU. What's the average speed——

Mr. AHART. Right now it can——

Senator SUNUNU.—to market nationally?

Mr. AHART. Sure.

Senator SUNUNU. How would it affect the speed to market, either as a percentage or a reduction in months, weeks——

Mr. AHART. Absolutely.

Senator SUNUNU.—days?

Mr. AHART. It can take up to 18 months now to get new products formed. And, at times, companies put in new forms or rates, and actually so many years go by, where they just ignore them and don't do anything with them anymore and try to do a new product, so that opportunity has been missed, where this would actually do everything within 30 days.

Senator SUNUNU. But you haven't set a specific goal with your legislative proposal that you want to reduce time to market by 3 weeks or by 10 percent or by 30 percent?

Mr. AHART. Well, it would——

Senator SUNUNU. Do you——

Mr. AHART.—reduce everything——

Senator SUNUNU.—try to quantify——

Mr. AHART.—to 30 days. So, I mean, and all those ones—I don't think there's anything out there that is quicker than 30 days. There are ones out there that take 18 months, there are ones out there that take forever, and so it would——

Senator SUNUNU. Fair enough.

Mr. AHART.—quantify it that way.

Senator SUNUNU. Why don't I defer to Senator Nelson and then we'll have a second round.

Thank you.

Senator NELSON. Thank you, Mr. Chairman.

All the old memories come back.

[Laughter.]

Senator NELSON. And you all have been an excellent panel. You've presented, most articulately, the questions in a changing environment in which change is needed.

Now, I approach this from the standpoint of—for a product that is essential for the functioning of our society, which insurance is, how can you best produce a product that is the most efficient at the least cost with the least amount of fraud that is an environment in which companies can offer a decent product and make a good living?

So, naturally, I'm going to ask the questions about the protection of the consumers and providing a healthy marketplace. Our experience in Florida—for example, with homeowners—was one of the most disrupted marketplaces in the world, of which the government had to step in, create quasi-governmental insurance companies to take up the slack when the insurance companies fled the state because of the massive losses from the most costly natural disaster in the history of the country to that point in insurance losses, Hurricane Andrew.

And yet the government wasn't going to be what was solving it. That was just temporary. What was going to solve it was to nurture that private marketplace back to life, to health, so that it could supply the product, in this case, of homeowners insurance.

So how do we blend all of this together? How do we get balance?

Now, let me ask a couple of questions here. First of all, I'm concerned, Mr. Csiszar, that the National Association of Insurance Commissioners, which had performed a magnificent service in the past, I'm concerned that it has lessened, because of the duration of an insurance commissioner's term, its ability to represent the best interest of consumers. Let me ask you, what is the average time that an insurance commissioner in a state is in office?

Mr. CSISZAR. I think you need to talk to George Dale, Mr. Nelson, I think George is the longest-serving commissioner——

Senator NELSON. That's not the question. The question is, what is the average time?

Mr. CSISZAR. Probably one Governor's term.

Senator NELSON. To the contrary. It's less than one year, the average time.

And where does that insurance commissioner usually come from, Mr. Csiszar?

Mr. CSISZAR. Not always from the industry or with the experience from the industry. Oftentimes from a political or a legal environment.

Senator NELSON. Usually that insurance commissioner is appointed because that insurance commissioner has knowledge of insurance and he comes from the insurance industry.

And at the end of his term, in less than an average of 1 year, where does that insurance commissioner, when he or she leaves public service, where do they go?

Mr. CSISZAR. I think the record there is that they do tend to go back to the industry or, in some shape or form, go to the industry.

Senator NELSON. And that's my concern. And that leads me to want to support an approach like Senator Hollings' approach, because not only of Gramm-Leach-Bliley—and, by the way, the U.S. Supreme Court case was—I guess it was Barnett Bank versus Bill Nelson. I was the one standing up for the insurance industry. I happened to be insurance commissioner at the time, inherited a case that had come—had started before my term. But on a technical reason, with a unanimous U.S. Supreme Court, they decided that, for technical reasons, the early in-the-century law said that banks could do insurance business. And so that led, ultimately, to enormous changes, that led to Gramm-Leach-Bliley. Enormous changes have occurred, and here we are.

Now, let me ask Mr. Hunter, you, I think, want some Federal participation here. It's the Federal charter that you're concerned with. Tell us about that.

Mr. HUNTER. Commissioner—I mean, Senator.

[Laughter.]

Mr. HUNTER. Well, you know, I've been an insurance commissioner, too, and I have, in my entire life, supported state regulation. And, as I say in my written testimony, I'm at a crossroads. I think state regulation is failing.

Now, I think CFA and I are going through a process, and I think we're going to come out that we support a Federal approach, like Senator Hollings, over and against the state approach, but we would not support a dual charter. We don't like that idea. But we would support a Federal approach that would be "the" approach for

at least some of the companies, perhaps along the lines of the Hollings approach, which I think makes sense.

But we have not finally crossed the Rubicon. We're having meetings with other consumer groups that are coming up. We're having a major summit of consumer leaders and others coming up. And that's going to be the primary question, are we going to move it toward abandoning our—my lifelong support of state regulation, which is hard. It's hard. It's, sort of, like leaving a church or something, you know. It's a difficult process.

Senator NELSON. It's been difficult for me, too.

Mr. HUNTER. But I am——

Senator NELSON. Because I saw how it could——

Mr. HUNTER.—I am at the Rubicon, you know.

Senator NELSON.—I saw how it could work, but I've also seen the flaws of how it doesn't work.

Mr. HUNTER. And I think, you know, to the—the Gramm-Leach-Bliley is only part of it. It's this massive giving away—a willingness to give away consumer protections over the last few years in order to preserve the turf, instead of saying, "Well, we'll preserve the turf by being strong and protecting consumers," which is what they should have done, in my view.

Senator NELSON. Mr. Chairman, may I ask two more questions, just so I—I'm kind of, you know, in a groove here——

[Laughter.]

Senator NELSON.—and I'd like to continue.

Mr. Berrington, you represent an association of which your leader, the president, Bob Bagley, is a friend, we've worked on things. You support a Federal charter, but there are many other associations that don't support the Federal charter. Tell me about that.

Mr. BERRINGTON. There are other trade associations in the property-casualty business that have different views. I think all of them recognize the problems that have been set forth this morning with regard to the current state of state regulation. And with—those organizations ought to speak for themselves, of course, but I know that there are companies within those organizations which are moving toward the idea of a Federal charter, an optional charter, with the rights kinds of standards—strong consumer protections——

Senator NELSON. Yes.

Mr. BERRINGTON.—and a competitive-based——

Senator NELSON. Do you support——

Mr. BERRINGTON.—regulatory system.

Senator NELSON.—the Hollings bill?

Mr. BERRINGTON. We have some difficulties with the bill.

First, the bill——

Senator NELSON. I don't want to get——

Mr. BERRINGTON. I'm sorry.

Senator NELSON.—into all the details.

Mr. BERRINGTON. No, it——

Senator NELSON. If you would submit it for the record.

You're inclined to look at it, but you don't necessarily support it. Is that it?

Mr. BERRINGTON. We don't support the prior-approval regulatory regime, rather than an Illinois-type of competitive regime.

Senator NELSON. How about you, Mr. Rahn?

Mr. RAHN. No. From the life insurance perspective, the approach that's taken in Senator Hollings' bill would not really work for us. The bill has been crafted primarily to address the property and casualty industry, and there would need to be accommodations made to address the life industry.

We also feel very strongly that there should be an option, that there should be an ability for the states to have a say, and insurance regulation to have two competing systems, and then to also allow companies, depending on their business, mix of products, and other things, to have that option.

Senator NELSON. OK. Let me move on——

Mr. RAHN. All right.

Senator NELSON.—because of the time here.

Final question is, Do you think—the Hollings approach, as I understand, does have the regulation of rates at the Federal level.

Mr. BERRINGTON. Right.

Senator NELSON. What's your opinion about whether or not a Federal panel can do regulation of rates?

Mr. BERRINGTON. Our view, Senator, is that there should be no rate regulation, that it should be a competition——

Senator NELSON. You would——

Mr. BERRINGTON.—like the Illinois——

Senator NELSON.—like to have no rate regulation.

Mr. BERRINGTON. That's—and we're prepared to give up the antitrust exemption to get that. The proposal, the Prop 103 approach, which is what's used in 24 other states——

Senator NELSON. Yes.

Mr. BERRINGTON.—has not been the cause of lower rates in California——

Senator NELSON. Well, let me just——

Mr. BERRINGTON. So we would hope—we would suggest a different regulatory regime.

Senator NELSON. I understand. And I'll tell you, it's going to be a long day before I can get to that point, because in the aftermath of Hurricane Andrew, when I was looking at rate increases of 200 percent, and I was the only thing standing between those rate increases and the consumer, there just simply is going to have to be some rate regulation somewhere in the process.

Mr. Chairman, thank you for your indulgence. I think, again, just—this is an excellent starting point. I think the Hollings bill is an excellent starting point. I think we can do some blending of ideas here. Market conduct, I think, in large part's got to be done at the state level, but this is the beginning of seeing if we can get some consensus. But, in this industry, Mr. Chairman, getting consensus on anything——

[Laughter.]

Senator NELSON.—is very difficult to do.

Senator SUNUNU. Thank you, Senator Nelson.

Mr. Berrington, I do want to give you a chance to just respond to the question, in the interest of fairness, regarding why you would be supportive of the optional charter proposal you talked about in your testimony and questions here, and what your con-

cerns would be about the mandatory regulatory structure proposed by Senator Hollings.

Mr. BERRINGTON. Thank you, Mr. Chairman.

We think the optional approach is one which is most likely to get consensus in the industry ultimately, because there are companies with different needs. Smaller companies have more comfort with a local regulatory regime. Certainly for national companies or large regional companies, the Balkanization that has occurred at the state level adds cost and is difficult to do.

We believe that the Federal approach, for those who choose it—let me come back to it for a moment, if I might—would be one that would have very tough consumer protections—it is not to the benefit of any our member companies that there not be tough consumer protections—tough financial regulation, so that we don't have the kinds of stresses going forward in the guarantee fund system that we have today, but one would that would, quite frankly, utilize competition for the establishment of rates.

There's been much talk this morning about Prop 103, and the conversation about Prop 103 has been basically in the context of automobile insurance. But Prop 103 really related to all insurance except workers' compensation. And the—what it did do, Senator Hollings, because your bill follows that approach—what it did was to take, as a rate regulatory approach, something which is called a prior-approval system with a deemer. That's insurance talk. Commissioner Nelson certainly recalls that, and you may well, from your days as Governor. But basically the approach that was taken by Prop 103 was already the law in 23 other states with regard to workers' compensation.

The changes that have resulted in California automobile insurance rates coming down have had nothing to do with Prop 103. Indeed, the rates did not begin to come down until six or seven or 8 years after Prop 103 was passed.

But what things happened during the interim? Among other things, California passed a very tough seatbelt law. We all know that the greater the use of seatbelts, the lower the injury levels there are in accidents. It also passed legislation which stopped the subsidization of high-risk drivers by those in the regular market. That brought rates down dramatically, as well. It took other reforms. And as those began to work through the system, they brought rates down.

But as Senator Lautenberg said earlier today, New Jersey has had some of the highest rates of auto insurance in the country. They had almost exactly the same prior-approval system that California had. The difference, I think, should be drawn not between California and the rest of the country, but between California, which does not rely principally on competition for rate regulation, and Illinois, which does, and has for decades.

Let me just show you quickly a chart. This is homeowners insurance, which is also regulated by Prop 103. Here is the comparison between homeowners insurance rates in California and in Illinois from 1991 through the year 2000, just after Prop 103 got its legs, so to speak. In every year, homeowners insurance rates in Illinois, also a state with substantial population density and rural areas, has been 40 percent less, approximately 40 percent less, than what

they pay in California. If Prop 103 were the magic elixir, why didn't it bring down rates with regard to homeowners insurance to the same level as Illinois?

Senator SUNUNU. Mr. Berrington, you're welcome to submit that for the record, and I'll give you a minute to conclude your answer.

Mr. BERRINGTON. Sure.

Senator SUNUNU. But I just want to note that we'll go to Senator Hollings after the conclusion of your answer to my question.

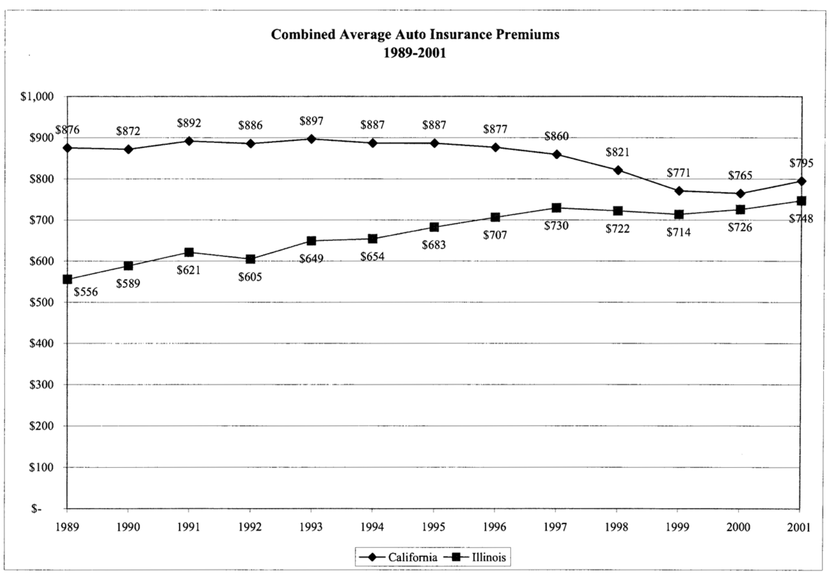
Thank you.

Mr. BERRINGTON. Thank you very much. I appreciate the indulgence.

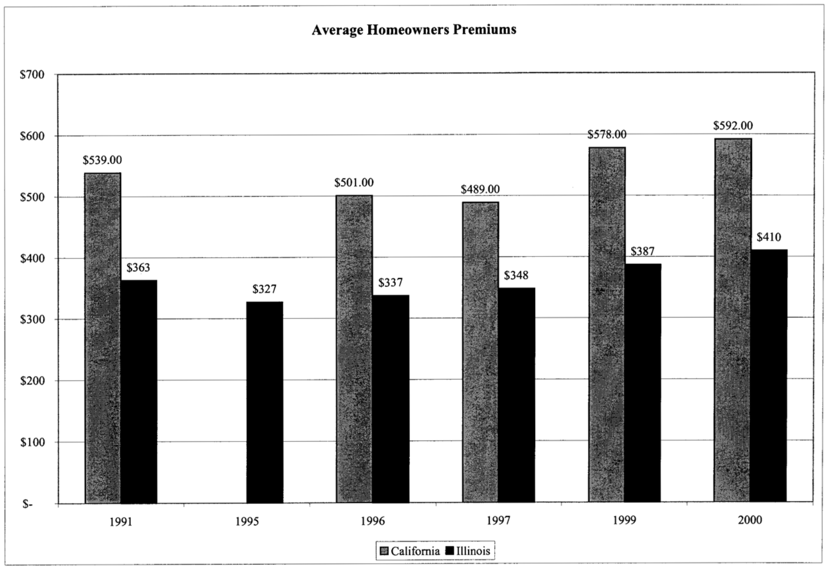
And I would also like to submit for the record the California auto insurance premium chart, which, as you can see—this is Prop 103, and the rates didn't start to come down until many years after that, and in every——

Senator SUNUNU. Without objection.

[The information referred to follows:]



Note: Proposition 103 was passed in 1988. California premiums began to drop after 1995 for reasons unrelated to Prop 103, as discussed in the attached "Myths and Facts" document.
Sources: NAIC premium studies, American Insurance Association



Sources: Insurance Information Institute, NAIC. American Insurance Association analysis
Note: HO premiums do not include earthquake premiums. Data is for comparable insured values.

MYTHS AND FACTS ABOUT CALIFORNIA'S PROPOSITION 103, INSURER INVESTMENTS, AND WORKERS' COMPENSATION REFORM

In recent testimony before the Senate Committee on Commerce, Science and Transportation, Douglas Heller (Foundation for Taxpayer and Consumer Rights) and Robert Hunter {Consumer Federation of America) made claims about the purported benefits of California's Proposition 103 {"Prop 103"); insurance company investments; and the impact of various reforms on California's workers' compensation system.

We do not believe their claims have merit, but since their long-term agenda includes trying to federalize a Prop 103-type insurance regulatory system, it is critical that policymakers understand the nature of Prop 103. In addition, their erroneous assertions about insurer investment practices and how rate regulation reforms affected California's workers' compensation system should not be allowed to go unchallenged. Therefore, set forth below are myths and facts about each of these issues.

I. Myths about Proposition 103

Myth: Prop 103 saved the California auto insurance market through its prior approval regulatory structure.

Fact: While everyone agrees that the California auto insurance market improved dramatically, it was not due to Prop 103. Prop 103 set up a government-centered price control system for insurance, in contrast to market-based rate regulation. Numerous academic studies, have demonstrated conclusively that states with prior approval regulatory regimes have more significant problems in their insurance marketplaces than states that allow free market competition.

In fact, the California *auto* insurance marketplace improved because of other factors {e.g., lower liability costs, improved fraud detection, and greater public safety) and in spite of Prop 103. It is critical to underscore that substantial premium savings did not occur in the auto insurance market until nearly eight years after Prop 103 had been approved. During those years, other policy changes that impacted accident rates, loss costs and the claiming environment were being implemented. All of those had a meaningful and positive impact on the auto insurance market.

Myth: Since Prop 103 was successful in California, it should be used in other states and nationally.

Fact: As stated previously, Prop 103 did not stabilize or improve the insurance market in California. Its essential regulatory mechanism (price controls) has failed

in states that use it. Moreover, if Prop 103 had been good for insurance markets and consumers, it also would have helped the homeowners insurance market in California. In fact, average homeowners premiums in California in 2000 were 44 percent *higher* than in Illinois, a state which has market-based regulation and price flexibility. As the attached chart shows, California's homeowners insurance premiums were consistently higher than those in Illinois during the 1990s.

Those offering Prop 103 as ideal regulation fundamentally misrepresent both insurance and economics. The prices consumers pay for insurance (premiums) are generally based on the underlying claims costs associated with their policies. Consumer advocates incorrectly argue that auto insurance premium decreases following Prop 103's passage were due to its "rate rollback" provisions, rather than the more obvious explanation: that the decreases were a direct response to declining loss costs.

Myth: Arguments that substantial decreases in claims costs in California, rather than Prop 103's price regulation, were responsible for reducing auto insurance premiums in California are subjective and just insurance industry "spin."

Fact: In addition to the overwhelming academic research on the destructive effects of price regulation on insurance markets and consumers, there has been empirical analysis specifically on Prop 103 and the California auto insurance market. David Appel, Ph.D., a principal with the actuarial firm Milliman, USA, and one of the Nation's foremost scholars on insurance regulation and an expert in actuarial science, analyzed the specific claims of alleged benefits of Prop 103. His carefully specified econometric analysis [1] of the California experience indicates that Prop 103 had *no statistically significant impact* on California loss costs. Put simply, factors other than Prop 103 brought claims costs-and premiums—down.

So what brought loss costs down?

- *Fundamental changes in the tort system:* A court decision in 1979 *(Royal Globe)* unleashed an onslaught of litigation in California courts, both for auto liability claims as well as other liability claims. Between 1980 and 1987, California Superior Court auto liability claims filings increased 82 percent. In addition, average claim severity quadrupled, leading to dramatic increases in auto liability insurance costs—and premiums—in the state. In 1988, the year that Prop 103 passed, the California Supreme Court overturned the *Royal Globe* doctrine (in *Moradi-Shalal);* the court even acknowledged the "undesirable social and economic effects of the [previous] decision . . . [such as] excessive jury awards, and escalating insurance, legal, and other 'transactions' costs." This dramatic change in the legal environment was a significant and crucial factor in reducing claims costs in California.
- Policy initiatives on safety, fraud, and excessive claiming behavior helped to reduce loss costs as well: Seat belt usage increased substantially and the blood alcohol standard for driving under the influence of alcohol (DUI) was reduced to 0.08 percent in 1990. None of these changes were part of Prop 103, and all of them occurred wholly separate from Prop 103. Moreover, the enforcement of DUI laws intensified; this resulted in the number of DUI-related claims dropping substantially, by about 60 percent through the 1990s.

  The California legislature also passed laws (*e.g.,* SB 953 in 1991) that aggressively cracked down on fraud and excessive claiming behavior. Additionally, there were dramatic increases in the California Department of Insurance anti-fraud budget. As Appel notes in his analysis, by 1998, the empirical factors actuaries use to measure fraud and claiming behavior (*e.g.,* the Bodily Injury to Property Damage ratio), which had been 2.3 times higher for California in 1992, dropped to rough parity with the rest of the Nation by 1998.

  The effect of these initiatives was dramatic, Appel determined. Average claim cost growth slowed substantially in California, compared to the rest of the Nation, and the slowdown was particularly greater for liability-related coverages than for physical damage and theft coverage, which would be expected given the positive changes in the litigation environment.

Myth: Even considering other factors, Prop 103 did no harm to California's insurance market.

Fact: The Appel econometric analysis showed that California consumers could have saved in excess of $10 billion from 1989 to 1998 had market based pricing been permitted to function in the place of Prop 103's price controls. Appel notes that the post-Prop 103 regulatory environment in California was likely to induce insurers to defer reductions in premiums in response to declining costs. Why? Because they feared

[1] *An Analysis of the Consumer Federation of America's "Why Not the Best?,"* David Appel, Milliman, USA, December 2001.

that regulatory "rigidity" would not allow them to raise premiums if costs rose again in the future. By interfering with market forces, and the ability of insurers to compete in that market by raising or lowering premiums in response to changing costs, Proposition 103 was, and continues to be, detrimental for consumers.

Myth: The antitrust exemptions provided to insurers are anti-competitive and allow companies to set prices collusively rather than compete against one another. The industry can act in concert to raise prices at a future date. Without the antitrust exemption, insurers would need to price more reasonably and based on their actuarial needs because they would not be assured of the higher future prices that collusion allows.

Fact: Setting aside for the moment the fact that insurers do comply with antitrust laws, this scenario does not accurately portray how companies operate in the marketplace. From an economics perspective, the idea that firms collude together, even tacitly, in a competitive market—and the insurance market is very competitive—by acting in concert to raise or keep prices higher than warranted by actuarial standards is not borne out by either real world experience or economic theory. In order to succeed in the market, insurers must keep premiums as low as possible in order to keep their customers from shifting their business to another insurer. Any attempt by a company to keep prices artificially high in order to gain additional profit would allow that company's competitors to increase their market shares by merely lowering their prices.

Premium data for California indicate that insurers were reluctant to significantly lower prices in auto insurance until 1996—eight years after Prop 103 was passed and when it was clear that the favorable loss trends generated by non Prop 103 factors (discussed elsewhere) were substantial and relatively permanent. In a market-driven system, insurers would have been free to raise and lower prices as needed,.

Myth: Prior to Proposition 103, auto insurance premiums in California rose dramatically each year. The average auto liability premium dropped 22 percent in California between 1989 and 2001 while premiums throughout the rest of the Nation rose 30.2 percent.

Fact: As detailed above, auto liability insurance premiums dropped substantially in California because of the favorable changes in the litigation environment, improving safety and reduced fraud, not because of Prop 103. Two trends explain both the drop in California's auto premiums and the simultaneous rise of such premiums in the rest of the country. First, until 1989 and the legal decisions and policy changes that resulted in decreasing liability costs, California was a litigation nightmare for insurers. Since then, costs (and premiums) have dropped to about the national average. Second, the overall litigation environment in the Nation has worsened in recent years, thus becoming more costly to both insurers and consumers as a general matter.

II. Insurer Investment Practices

Myth: Insurers have foregone their traditional conservative investment philosophy and strategies for maintaining reserves (in order to pay future claims payments) in favor of riskier stock market and other exotic investment products.

Fact: The property-casualty insurance industry invests very conservatively, putting a large majority (ranging from 66–71 percent over the last decade) of its investments for future claims payments in U.S. government, municipal, special revenue, and public utility bonds. While there was a slight increase in the proportion put into common stock during the 1990s, investment in highly stable bonds still continues to dominate property-casualty insurance. The percentage invested in common stocks grew from 16.1 percent in 1991 to 20.8 percent in 2001, when property-casualty insurers held 66.1 percent of their $782 billion total investments in bonds. By being one of the largest investors in state, municipal, and special revenue bonds, the property-casualty insurance industry not only exhibits stable and conservative stewardship of funds for claims payments, but also makes major contributions to the public infrastructure and economic development of local communities and states.

Myth: Property-casualty insurers lost substantial amounts of their investment portfolios in such stocks as Enron, WorldCom, Tyco, and volatile high tech/dotcom stocks such as AOL, Cisco, JDS Uniphase and others. Losses in these stocks by some insurers constitute evidence of risky investment behavior on the part of property-casualty insurers and are the cause of recent insurance price hikes.

Fact: This is patently false. Important and well-known factors, such as World Trade Center terrorism losses, water damage and mold claims, and natural disaster losses, have dramatically increased insurance losses in recent years, and have led, in turn, to increases in insurance prices. In addition, rising liability insurance losses caused by an aggressive lawsuit industry have greatly destabilized the insurance marketplace.

In recent testimony, one group tried to suggest that $37 million insurers lost from the bankruptcy of Enron was responsible for premium increases. Insurers were not the only ones who lost money because of the Enron scandal. Millions of investors, and sophisticated mutual funds, brokers, and pension funds lost billions. However, relative to the $782 billion that property-casualty insurers invest annually, the Enron losses represent less than one thousandth of one percent (.005 percent) of annual investments. Even when other losses such as those from WorldCom are included, the overall impact is trivial as a percentage of overall investments. This group also failed to acknowledge that many of the other stock losses cited may eventually be recovered as those companies' financial conditions improve. Because insurers are most heavily invested in less volatile bonds, they can often wait to recover some losses on stocks, since stocks comprise about one-fifth or less of the industry's investments.

Myth: A Proposition 103-style prior approval state regulatory system will result in less risky investment practices on the part of insurers.

Fact: As previously highlighted, investment practices are already very conservative in the property-casualty insurance industry and covered by solvency regulation, industry best practices, and state laws. The addition of a Prop 103-type regulatory system would not improve investment practices or solvency regulation because the major focus of Prop 103 is command-and-control price and product regulation. Prop 103 could threaten the efficacy of solvency regulation by channeling resources and focus away from the kind of oversight and enforcement functions that truly benefit consumers and form the foundation of a financially healthy insurance market. A regulatory system that relies on competition, state and Federal antitrust provisions to regulate prices and products, on the other hand, can concentrate resources and expertise on solvency and market conduct regulation, ensuring the viability of the insurance marketplace.

Myth: Insurance companies make all of their profits off of investments and routinely expect to lose money on underwriting.

Fact: This statement is palpably untrue. As a general matter insurers attempt to price products so that a reasonable profit can be generated from the insurance operation itself. Property-casualty insurance is a highly competitive business with over 1,100 major insurer groups representing nearly 4,000 companies. As such, there are differing assessments of the correct balance of underwriting and investment profit. In an environment where investment returns allow for a premium to be decreased, the competitive marketplace may result in those reductions. This may vary by line of insurance, with some insurers electing to consistently make underwriting profits in every line of business they write.

Myth: Insurers resort to a "tort reform" strategy whenever interest rates decline and the investment environment becomes tougher.

Fact: Property-casualty insurers are the biggest players in the U.S. tort system. As such, the industry seeks tort reform not as a convenience, but because reform of the tort system will result in decreased litigation costs. Because of the steady increase in class action lawsuits, the aggressiveness of the trial bar in asbestos, medical malpractice, product liability, and even new areas, such as obesity, claims costs have soared. When insurance losses increase because of these rapidly rising liability losses tort reform is urgent and must remain an important goal through periods of both good and bad environments for underwriting and investments.

Myth: Tort reforms never result in a stabilization of insurance costs and premiums and are used by insurers as a ruse to hide their poor results in investments.

Fact: Substantial tort reforms in the late 1980s in many states, following a major escalation in the frequency and severity of lawsuits, did lead to a marked stabilization of liability insurance costs and premiums that lasted through much of the 1990s. Tort reform was a key factor in producing more stable insurance prices, and, along with robust competition among insurers and good investment results, resulted in billions of dollars in savings for commercial and individual consumers during the 1990s. There is simply no getting away from the fact that underlying claims costs are the major part of insurance premiums, and to the extent that tort reform can reduce fraud, questionable and exaggerated claims, and novel lawsuits, it can significantly help to keep claims costs—and premiums—in check.

III. California Workers' Compensation

Myth: Workers' compensation has not been as profitable in California as it has been nationally because of price deregulation in 1993. Because of "deregulation," the California workers' compensation system is currently in crisis because insurers became foolish, engaged in cut-throat competition, and underpriced their products.

Fact: There are numerous inaccuracies in the above claims. Regulatory modernization, brought about by a more market-driven rating law for workers' com-

pensation in 1993, saved California businesses and consumers billions of dollars in the first six years following implementation. The 1993 reforms repealed the so-called "minimum rate" law, through which the government established the final price of workers' compensation insurance and thereby prevented workers' compensation insurers from giving employers greater choice of carriers. By enacting a more modern rating system, California eliminated a rigid government price setting mechanism, thus finally allowing some price competition in the workers' compensation marketplace. However, California did not relinquish its authority to prevent workers' compensation rates that were "inadequate." Thus, if at any time California regulators thought that an insurer's rates were in fact "inadequate," the regulators had the right and the responsibility to reject that rate.

Rather, the problem with the California workers' compensation system is an absence of system controls over medical treatment costs and payments for lost wages, combined with a hyper-complex statute generating a high level of dispute and litigation. Average ultimate loss per indemnity claim in California has more than doubled in the past 6 years—from $25,849 in 1996 to $52,142 in 2002.

Although workers' compensation reform was a significant issue in the recent campaign to recall Governor Gray Davis and election of the new Governor, it is telling that none of the major candidates advocated a return to price controls or a Prop 103-type regulatory regime for California's workers' compensation insurance. Indeed, all pointed correctly to system costs as the culprit.

Contending otherwise is merely an attempt by those with a stake in keeping the current dysfunctional system to change the subject.

American Insurance Association, December 2003.

Mr. BERRINGTON.—and in every single year, Illinois auto insurance rates, relying on competition, have been less than in California.

Thank you for your indulgence.

Mr. HUNTER. I'd like to also submit something——

Senator SUNUNU. Senator Hollings——

Mr. HUNTER.—responding to that, if I could.

Senator SUNUNU. Without objection, Mr. Hunter, you'll be allowed to submit whatever you'd like for the record.

[Mr. Hunter submitted the Consumer Federation of America "Industry Comments on CFA Study of Insurance Regulation in California" available at *www.consumerfed.org* and retained in Committee files.]

Senator SUNUNU. Senator Hollings?

Senator HOLLINGS. Mr. Berrington and Mr. Rahn both complete your statements for the record, not just this minute, but fill it out and submit it to the Committee, because I'm anxious to find out what's the best way to do it. I've been looking at it—incidentally, I've been the state fellow protecting state's rights up there for so many years. And Mr. Csiszar, when I changed insurance commissioner, I not only put him in there, but I put a lot of Hollings people in there that got jobs——

[Laughter.]

Senator HOLLINGS. You talk about Federal bureaucracy.

[Laughter.]

Senator HOLLINGS. I filled up the state bureaucracy with it.

[Laughter.]

Senator HOLLINGS. I've been up here 37 years, and I haven't gotten anybody a job at the FAA, the FTC, the FCC, the Defense Department. Now, Strom did.

[Laughter.]

Senator HOLLINGS. He knew how to do it. But I've been faulted for not getting everybody a job. Every time I call over to the De-

fense Department, they say, “Well, let them fill out the forms” and everything else like that.

[Laughter.]

Senator HOLLINGS. So I want that criticism, Mr. Rahn and Mr. Berrington, but let’s—incidentally, I organized the state life insurance company, the state life. It was bought out. Incidentally, I guaranteed insurance trusts before the Securities and Exchange Commission before Manny Cohen, the Chairman, in 13 days, and it still stands as a record, before the Securities and—all you’ve got to do is take the water out and all the fees out and all the racket out, and you can get a good company. And so when I get out the year after next, Mr. Berrington, I’ll be looking you up, because you and I can organize one and we can make money.

[Laughter.]

Mr. BERRINGTON. So we both have life after this.

[Laughter.]

Senator HOLLINGS. Really. It’s a sure shot, man, that mortuary table. You don’t lose.

Mr. Hunter, what’s your comment, please?

Mr. HUNTER. Oh, I just was going to respond to Mr. Berrington. I have been——

Senator HOLLINGS. Will you, please?

Mr. HUNTER. Well, I—we responded to all these points before, and I wanted to submit for the record the fact that the seatbelt use level has changed in every state. I mean, all these arguments are just bogus. California Prop 103 worked. It was—it’s different than New Jersey, it’s different than these other states he points to. It was unique, and it had a huge impact. When it became law, the rates were, like, $200 higher than Illinois, and now they’re almost even. So Illinois is no great shakes. It hasn’t driven rates down in Illinois.

Senator HOLLINGS. Mr. Heller?

Mr. HELLER. Yes, and, Senator Hollings, if I could just add one point. Mr. Berrington did note that workers’ compensation was not covered by Proposition 103. In fact, in 1993, California law deregulated, to open competition, the workers’ compensation market. And if anybody followed what happened in the California gubernatorial recall, one of the big discussions was a dramatic workers’ compensation crisis in which every single company has left the state. Our state fund, which is the state-subsidized insurance fund, has 56 percent of the market, and nobody else will sell policies. That’s the one line that is not covered by Proposition 103. It’s the one line that was subject to open competition, and it failed miserably.

Senator HOLLINGS. I just don’t understand Mr. Berrington’s comparison on property insurance, because Warren Buffett, he says that he doesn’t pay anything out there in California on his multimillion dollar properties; whereas, in Nebraska he’s got a very modest home and he’s paying a fortune. What’s the answer to that?

Mr. BERRINGTON. Well, I think, Senator Hollings, although I am—I follow California matters perhaps less than others, I think Warren Buffett was talking about property taxes, not——

Senator Hollings: That’s right.

Mr. BERRINGTON.—in California——

Senator HOLLINGS. He was talking about property taxes, but they ought to sort of parallel the insurance rate.

Mr. BERRINGTON. Well, he wasn't talking about insurance rates, I don't believe, but——

Senator HOLLINGS. No, I know he wasn't talking about insurance rates, but common sense would parallel it. Do you disagree?

Mr. BERRINGTON. I'm not sure I follow. All I'm—the point I'm trying to make is that homeowners insurance rates in California have been much higher consistently with a prior-approval regulatory system than homeowners insurance rates in a peer state, Illinois.

Senator HOLLINGS. Well, Mr. Chairman, let me thank you and thank the panel. This has been an outstanding panel, and anyone on the panel that has further submission that want to elaborate on the points made, please do so. The Committee is anxious to learn and put out the best product possible, because everybody wants some Federal options or Federal regulations or licensing or forms or whatever else, and I find out, in talking, whether or not to give that option. As they said, "For Lord's sakes, don't give us two systems that we've got to conform to." One bureaucracy, Mr. Csiszar, is enough, be it state or Federal. And yet I'm hearing they want that Federal option.

So thank you very much, Mr. Chairman.

Senator SUNUNU. Thank you very much, Senator Hollings. And perhaps before we close the record, we can find someone in the Senate that can answer for those high insurance rates in Nebraska.

[Laughter.]

Senator SUNUNU. Mr. Ahart, under your proposal, we would have Federal statute that sets certain minimum standards in a number of areas for insurance, but how would those standards or those requirements be enforced?

Mr. AHART. Yes. It would still be enforced on a state regulation basis.

Senator SUNUNU. And what if the headstrong members of Mr. Csiszar's organization don't agree with the statute, don't feel comfortable adopting those standards?

Mr. AHART. I mean, it would be Federal law, so, I mean, I believe they would have to follow Federal law. But if for some reason they wanted to challenge it, that's why they have the court system, the same way they can challenge things now.

Senator SUNUNU. So there aren't—would there be specific fines or penalties assessed on the states, or would it just be a question of encouraging further litigation?

Mr. AHART. Well, the—I mean, it could be drafted any way. The bill really hasn't been completely drafted yet, so—I mean, it's in the process, so things will all be looked at.

Senator SUNUNU. And are there other associations or insurance companies that have lent their support to this proposal, or is that something that you haven't done yet?

Mr. AHART. No, we've actually met with a lot of people, and I think we have a lot of support from different groups, specific insurance companies, even in associations that support Federal charters, that agree with our proposal and that believe that a middle-of-the-ground proposal is the way to go.

Senator SUNUNU. So could you provide a list of——

Mr. AHART. Sure, we'll provide——

Senator SUNUNU.—organizations, entities——

Mr. AHART. Sure.

Senator SUNUNU.—companies that are supporting——

Mr. AHART. Absolutely.

Senator SUNUNU.—the initiative, for the record, please?

Mr. RAHN. Mr. Chairman, could I respond to that, just——

Senator SUNUNU. Yes, please, Mr. Rahn.

Mr. RAHN.—on the life side?

You know, looking at it from the life perspective again, I think that the minimum standards approach, we would consider to perhaps be the worst place to start. In a sense, what it does is it, from a state rights perspective, forces upon the state certain things to happen. It could also allow the states to adopt additional requirements on top of those minimum standards, so you end up, again, with the lack of uniformity, that our industry seeks. And it really doesn't address the array of issues that need to be addressed. It's kind of a piecemeal approach. So that is why, from our association's standpoint, again, looking at it from the life perspective, we'd prefer to see an optional Federal charter addressing all those things rather than having just a minimum standards approach.

Mr. AHART. Can I just say that we don't—I mean, he's——

Senator SUNUNU. Please.

Mr. AHART.—interpreting that we're supporting minimum standards. We don't support Federal minimum standards. We support Federal standards, for instance in the rates and whatever. I mean, we've said what we support. It's not considered to be minimum standards.

Senator SUNUNU. I appreciate the distinction.

Mr. Rahn, is it fair to say that your biggest concern is speed to market?

Mr. RAHN. Well, it's clearly one of our biggest concerns. I think there are two focuses that we want to look at.

If you look at how the life industry has changed, it's gone from an industry that was pretty much considered not to be interstate commerce to an industry that is very interstate commerce and that is competing with other financial services industries. So that when we go to market, clearly getting speed to market is one of the key issues. But, in addition to that, if you look at how our business is regulated, even though we're state regulated, the tax writing and tax policy and pension writing of Congress really decides what types of products we'll have, what'll be available, how we go to the consumers. Once those changes are made, we don't have a presence here in Washington of a regulator that you turn to before those types of decisions are made. So I think one of the key drivers for us is having a regulatory presence.

In other words, when you're getting ready to consider tax legislation or pension legislation, unlike the banking industry or the securities industry, you don't have anyone to pick up the phone to talk to, and I think that was dramatically shown after 9/11 when there was not an insurance industry spokesperson to go to to immediately answer questions that were arising after that.

So speed to market is clearly one of the important aspects, but there's a whole array of things, from market conduct, Washington presence, and other things, that are important to us.

Senator SUNUNU. Have the compact proposals put forward by the NAIC addressed any of these concerns adequately, particularly with regard to speed to market?

Mr. RAHN. Yes. The NAIC is clearly trying to address some of these issues, but they're addressing it, again, on an incremental basis, which is how, when you're having to deal with over 50 jurisdictions, you're going to have to approach it. But if you look at the interstate compact, you're looking at a situation where we've taken 3 years to develop that compact. There's a hope that within a few years, by 2008 or 2009, we might have enough states to have the compact operational, and may have as much as maybe 60 percent of the market. That's simply too slow. In the meantime, you know, our industry continues to face competition and other things, so while we support what the NAIC's doing, that slow, incremental approach is not going to get us where we need to be, nor does it address the presence issue.

Senator SUNUNU. Mr. Csiszar, along those lines, one of your members—I have a wire-service report—was recently quoted as saying, "The current regulatory framework with each of the 50 states and the District of Columbia having individual licensing setups is akin to driving across the country and having to stop and get a new driver's license at every state border." This commissioner said, quote, "You would never get across the country. It would take you months. And, in my view, there's no reason for running the insurance industry that way." Now, that seems like a very strong statement from a member of your organization.

Mr. CSISZAR. And, actually, as director of the State of South Carolina, I would concur with that. My view, also, is that the process is too slow. That is why we're trying to change it, and that is why we have efforts such as the Interstate Compact, that is why we have a new electronic filing system, for instance, for rates and for forms served. So we're doing everything we can.

And let me—the timetable that you're looking, or that you heard, in a sense is driven by realism. And one of the realities at the state level is the fact that, for instance, not every legislature sits every year. We have states in which legislatures only sit every 2 years. So that from the standpoint of implementing the state compact, making the legislative changes that are needed, I think those states have to take that into account, and that's why you see the numbers where they are.

Senator SUNUNU. This commissioner also supported an exemption for large commercial insurers from having to obtain a license in every state. Is that something that you also concur with?

Mr. CSISZAR. I think that's something that's under consideration. At this point, I think—I don't think there's universal agreement on that within the NAIC, but there are certain—certainly, one of the avenues open in all of this is some type of domiciliary deference for licensing. So I think that's an open issue. While it is an open issue, I think there are those to whom it would have appeal.

Senator SUNUNU. I have one final question, and I'd like Mr. Rahn, Ms. Csiszar, and Mr. Heller to address it, just to get a spectrum of views.

First, how much is collected nationally each year in premium taxes? How much is used to fund regulation among the 50 states? And is that arrangement good for the insurance industry? And is it good for consumers?

Mr. Rahn?

Mr. RAHN. Thank you.

I—and Mr. Hunter may have it here—I don't have the exact number of what the premium tax collected are for—so you can—he can give you that number.

Senator SUNUNU. Can I suggest a working figure of about $10 billion? Mr. Hunter, will we agree on that?

Mr. HUNTER. Let me just—why don't you talk to them and I'll find the exact number for you.

Senator SUNUNU. Does somebody want to venture——

Mr. CSISZAR. It's the figure I'm getting.

Senator SUNUNU. Ten billion?

Mr. CSISZAR. That's about right.

Senator SUNUNU. OK. So we have—it's $10 billion in premium taxes. We can all agree on that? Maybe I should have started with Mr. Csiszar. What percentage of that is used to fund the regulatory efforts of your members?

Mr. CSISZAR. Our collection—well, I don't know the average, to be honest with you, but I think we can get you those.

Senator SUNUNU. I'm actually a little bit more curious to know the aggregate. So of the $10 billion, what percentage of that is used to fund——

Mr. CSISZAR. I would have to get back to you on that——

Mr. HUNTER. 8.4.

Senator SUNUNU. $8.4 billion of the $10 billion?

Mr. HUNTER. 8.4 percent.

Senator SUNUNU. So less than 10 percent of that goes to fund the regulatory organizations.

Now the easy one, I suppose. Is that good for the insurance industry, those that are being regulated? And is that good for consumers?

Mr. Hunter, since you had all of that helpful information, I'll start with you.

Mr. HUNTER. Originally, the idea was to collect premium taxes to regulate insurance.

Historically, they've been running under 5 percent. The Consumer Federation of America, other consumer groups, and the agents got together and worked on a proposal for at least trying to reach 10 percent, as a minimum, required to get consumer protections, based upon an analysis we did. And the agents groups and we put some pressure on, and we moved it up slowly year by year. It's now at 8.4 percent, which is better, but it still doesn't even meet our minimum requirement for what needs to be done. That's why there are so few market conduct exams. That's why market conduct exams are an abject failure to——

Senator SUNUNU. But should the goal——

Mr. HUNTER.—protect consumers.

Senator SUNUNU.—should the goal be to attain a particular percentage to achieve——

Mr. HUNTER. No.

Senator SUNUNU.—these goals, or to attain——

Mr. HUNTER. No.

Senator SUNUNU.—an appropriate level of spending?

Because I'm sure the states——

Mr. HUNTER. Yes.

Senator SUNUNU.—could hit that goal by just——

Mr. HUNTER. Yes.

Senator SUNUNU.—they could just double——

Mr. HUNTER. No, of course. We——

Senator SUNUNU.—double the tax and spend twice as much, but still not be spending——

Mr. HUNTER. When we came out——

Senator SUNUNU.—10 percent.

Mr. HUNTER.—with the 10 percent goal, working with the agents groups, we, obviously, split it up between various things that needed to be done to protect consumers, including upgrading market conduct, which is not—it's not a new problem that we see in market conduct; it's a problem decades old.

Senator SUNUNU. Mr. Rahn?

Mr. RAHN. Yes. From the life insurance perspective, it's correct, most of the premium tax is used to go to state general funds and is not directed, as the numbers show, to insurance regulation, generally. That can also take place in the form of fees that aren't—that are imposed on insurers and don't take the form of premium tax. To a certain extent, our view on that is—and that's been a cost of doing business in a state. Just like any other entity doing business in a state, there is a cost for doing business in that state.

One of the things I want to clarify is that if you look at the optional Federal charter approach that we've proposed, and others, we would keep that premium tax in effect. There would be no loss of premium tax to the states as a result of the optional Federal charter.

Now, you may ask, from the insurance company perspective, why would you do that when you have this cost? Well, we think that the cost of having a Federal regulator, in terms of fees that would be imposed on us to have that system, would cost us more; but, in the long run, having one system of regulation would be so much more efficient, we'd still come out ahead in the aggregate. And I think you would get, you know, a better, more streamlined, uniform approach to regulation in the outcome, also.

Mr. CSISZAR. Well, let me respond, first of all, to the comment about the taxes. We think that that's utopia. The reality of it is, and the history seems to show, that if you're going to have regulation at the Federal level, that tax is going to go, eventually, to the Federal level. So we are very concerned about that. But that's not our prime concern.

Insofar as the level of spending is concerned, let me say this. It really—it has to vary by state, and I don't think you can set a necessary target level of 10 percent or of premium taxes or 5 percent. We operate, for instance, at 5 percent, but I only have about 50 domestic companies. Whereas, a state such as New York or Pennsyl-

vania may have three or four or five or six times that number of domestic companies, and we defer to their analysis.

So the level of employment, the level of activity within the department really varies from state to state. So I think that the target approach is not one. It's a question of, given what is necessary within a given state, what needs to be done? Is that being done? And I think, quite frankly, South Carolina, we're at 5 percent, and we do a pretty darn good job at it. So I think the question really has to be addressed in the context of the different departments.

Senator SUNUNU. But why not support a system whereby premium taxes are leveled at a rate sufficient and necessary to pay for the regulatory burden and the resulting reduction in premium taxes are passed on to benefit consumers?

Mr. Heller?

Mr. HELLER. Yes, thank you, Mr. Chairman.

I think this question is very important, not only to the question of taxes, but to the broader issue of regulation. We can't forget that most insurance companies don't pay other taxes, other than their premium tax. So this is, in a sense, a great benefit, and they pay very—it's a substantial amount of money, but as an exchange for the gross premium tax, you avoid other taxes.

The amount of money that's being spent on insurance regulation state by state is really the big problem, the fact that there isn't enough being appropriated to the regulator from this—what should be considered an insurance regulation tax. And when you discuss issues of speed to market, from the consumer perspective it's not speed that matters, it's quality of regulation and the quality that get into the marketplace, just as you would want—you need drugs to go through a vetting process at the FDA before they get to market. You don't want speed, you want quality.

If you have the right amount of money put forward to the insurance regulator and they were able to actually go ahead and regulate, as we do in California—we do a pretty good job, though there are certainly many flaws—then you could actually have, if not the fastest market, you could have the best marketplace. And I think appropriating the right amount of money to the regulators would be a very good start.

Senator SUNUNU. Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman. You've started a very important line of inquiry with regard to the premium tax.

Senator HOLLINGS. Excuse me, too. Our bill retains the premium tax.

Senator NELSON. Yes, sir.

And, indeed, the testimony that you just elicited from Mr. Hunter, that 8.4 percent of the total $10 billion in premium tax actually goes to the regulatory function, says that this is a nice little source of revenue for the states to be used on other things other than insurance regulation. And that ought to be addressed in this whole issue. So I appreciate you bringing it up.

Since we're limited on time here, and that's why I was rushing through before. I didn't know that I could get back here, because other things that are going on this morning. What I'd like to do, Mr. Berrington and Mr. Rahn, since your industry is split on the issue of the Federal charter, if you could have Governor Keating

and Mr. Bagley come in and let's discuss this, because just in, for example, life insurance, the National Alliance of Life Companies opposes the Federal charter; whereas, you all support it. On the P&C, the AIA, as you've testified, supports it, but the AAI, the NAII, the NAMIC oppose it; whereas, the reinsurers support it.

So there's nothing unusual. I mean, this is typical of the insurance industry, but let's see what we can get in the way.

And now, to follow up, let's take the Hollings bill as a starting point. Licensing and standards for the insurance industry, it provides that this Federal commission would do that. Is that generally supported by this panel here? Licensing and standards for the insurance industry? Not long answers. I'm just trying to get concepts.

Mr. BERRINGTON. For those that chose the Federal approach, all of this would come within the Federal regulatory regime. Whether it be a commission or the Treasury Department, which we propose, is a different issue.

Senator NELSON. Anybody violently disagree with this——

Mr. AHART. Yes.

Senator NELSON.—at a Federal commission?

Mr. AHART. Senator, from the agents' standpoint, we would disagree with it. Again, we think that that should be done on a state basis and just attack the issues. I mean, most of this is—unfortunately, is just general and it doesn't deal with specific issues. It's passing the problem on to a Federal commission, and it could be the same problems you have at the state level. So it doesn't really address specific issues of speed to market or licensing, uniformity, things like that. It just says we're going to switch it to this group. They could do as poor a job, or poorer, than most of the states in the country.

Mr. RAHN. I'll offer you two quick comments. I think that the Federal regulator should have the responsibility for those. Our proposal is that they be based upon the best of the best of the existing state models and state laws.

Second, one disagreement that we have, and I think that there needs to be further consideration of, is whether the regulator should be in Commerce or Treasury, which would be the more appropriate regulator, who could do the regulations, has the most experience.

Senator NELSON. OK. How about another requirement under the Hollings bill for the Federal commission would be annual examinations and solvency review. Does anybody violently disagree with that?

[No response.]

Senator NELSON. How about establishment of accounting standards? Does anybody violently disagree with that, by a Federal commission?

[No response.]

Senator NELSON. OK. Well, then you get down to investigation of market conduct. Anybody violently oppose that?

[No response.]

Senator NELSON. Mr. Hunter?

Mr. HUNTER. No.

Senator NELSON. How can a Federal commission do the market conduct in 50 states?

Mr. HUNTER. Well, first of all, most insurance companies operate in 50 states. Most of the big companies where, for example, the Prudential and Met Life type crises that we had in market conduct were national in scope, and they were training people how to do these bad things. No one was catching it until lawsuits started occurring. Those could—might have been caught by a Federal market conduct review if it was done well by FTC or somebody who was interested in consumer protections. And it seems to me that those could have been caught.

Now, it's true, when you get to smaller companies, I think Mr. Hollings—under the bill, the smaller state-based companies would not be regulated by the Federal entity, and, therefore, those smaller companies would remain subject to a market conduct review by the states, as I understand the bill.

Senator NELSON. In that one case that we busted open, where we found a major national company was charging higher rates for African Americans for small-value burial policies, we busted that open, because, I mean, we dug, and we dug, and we dug, and we found it. Would a Federal commission be able to do that as well as a state regulator?

Mr. HUNTER. Obviously not today, because the state regulators have the horses today. But a Federal commission could, yes, because there are several—it was more than one company, by the way. Some of the companies sent—the NAIC was onto it a decade earlier than you caught it, and they sent out surveys saying, "Are you doing it?" And a lot of companies just lied and said, "No, we're not." And so the NAIC might have caught even earlier. A Federal regulator, if it had sent out a survey, might have caught it even earlier, but they might have also been lied to. I think it's possible. Obviously, it would take time, and, you know, there would probably need to be some kind of transition.

Mr. HELLER. Senator Nelson, if I could just add one point, because we do have some concerns. And where Bob is at the Rubicon, we're still a little bit more protective of the state's right to regulate. Perhaps that's because we've seen some good success in California.

It is our view, on the whole, that as you get more local with insurance products, which in many ways can be very local, and the issues are very local, the market conduct should, and we still retain the view that they should be regulated by the state. But what we appreciate so much about the Senator Hollings approach is that it does take a comprehensive approach, and it wants to do it seriously. Our fear is, of course, that if you lose the seriousness and the diligence that's, I think, implied by this approach, then you get into a world which is much more dangerous than the state-by-state approach. So we would certainly reserve our faith in the state market conduct approach at this point, because we think, at the local level, there is a greater understanding of the local problems.

Mr. RAHN. Senator, I would——

Senator NELSON. The final Hollings standard for the Commission would be the regulation of rates and policies. That, of course, is a controversial one. Do you want to give just a quick summary of that?

Mr. RAHN. Yes. With regard to—that's where I think that the bill is drafted more in line with P&C requirements than life require-

ments, and I think there would have to be some accommodation for the way that life products are regulated. We do think that the product approval process is broken and that a new process needs to be put in place in that.

The other thing I wanted to say on market conduct is, you already have examples of very powerful and effective Federal regulators that do market conduct standards—the SEC, the Department of Labor, and others—so I'm sure that a Federal regulator could work out a system that would be quite effective.

Senator NELSON. And I appreciate that. I just—you know, you come to the table from your own experience, and I remember that so many things, how we found them was because we paid attention to complaints that we were getting out in the field with our examiners or with our outreach office. We'd get these complaints, and you'd have to diligently follow up, instead of a cursory kind of looking at it, and then dig underneath and you'd find some of the bad practices that were going on.

Well, this is certainly going to be an interesting——

Mr. CSISZAR. Senator, if I can only add to that, I would—obviously, we feel the same way with you, and I think if what you're looking at, for instance, in New York these days with investigations being carried on against mutual funds, with the investigations that were carried on with the various banks and the investment banks, they were at the state level, and they were driven by the state level. So I think I would share that concern about the difficulty that a Federal commission would have.

Senator NELSON. Well, Mr. Ahart, you spin up your agents, because they have—politically, they have the effect on the system, because there's an agent in everybody's hometown. And y'all start working on this, because obviously the trends are moving in this area, and something's got to be done.

I think Senator Hollings' bill is a good first start. Now let's see what we can do with it.

Senator SUNUNU. Senator Hollings?

Senator HOLLINGS. Yes, thank you, Mr. Chairman.

Mr. Csiszar is an excellent witness. He goes right away to Spitzer. But Spitzer is the exception. The GAO report, Senator, was exactly what they found, the biggest fault with the state regulatory bodies. They had come up to snuff, so to speak, on solvency, because they had all kind of difficulties during the 1970s and 1980s. So they had gotten uniformity there, they had looked into the solvency, but practically no market conduct surveys. That was the GAO report. So the states are not doing it. They might have the capability, but they've not been doing it at all. That was the criticism in the GAO report.

Senator SUNUNU. Thank you.

Senator Hollings, I have a couple of final questions. Let me begin with you, Mr. Ahart.

Senator Nelson mentioned the agents—I mean, thousands and thousands of agents, for the most part entrepreneurs, small-business owners, family owned businesses—and those issues broadly get a lot of discussion and focus here in Congress, and for good reason. And I don't know that you've had an opportunity to talk directly from their perspective on the optional charter issue, in par-

ticular. What kind of concerns would you want to be addressed, or do you have, with an optional charter proposal?

Mr. AHART. Yes, well, I mean, first of all, we would oppose any kind of Federal charter, Federal commission, or Federal department of insurance, any kind of Federal bureaucracy, which is promulgating standards. You know, we truly believe that it should be Congress that mandates uniform standards, and that the states then regulate it. And those should be only on the issues that need to be addressed.

As I've said before, you know, a lot of our consumers and our agents like dealing with their states when there are problems and consumers have problems and they want to deal with a regulator. They feel comfortable talking with their state. I find it very hard to believe that they would feel very comfortable calling somebody in Washington, D.C.

So, you know, once again, our issue is to deal with the issues that are a problem. And as those issues are a problem, we can deal with them with Federal legislation.

Senator SUNUNU. Do you prefer the optional approach to Senator Hollings' bill? And are your concerns with the two different approaches the same, or do you——

Mr. AHART. The concerns are——

Senator SUNUNU.—have different concerns——

Mr. AHART. No, the concerns are basically——

Senator SUNUNU.—with the different approaches.

Mr. AHART.—the same—is that, first of all, neither one of them is proven. Basically, what you're doing is switching state regulation to Federal regulation without specifying exactly what you're doing, and that body could have the same problems—or could have the same problems that some of the poor states' regulations are having. So I don't think it ever solves the problem, and we're more concerned with solving the actual problems that we see, which most people are saying is—in fact, everybody's testified to—is speed to market, uniformity in licensing, and consumer protections.

Senator SUNUNU. Well, thank you, to all the witnesses, for your time, for your input. As we have indicated, you'll be allowed to submit additional information for the record.

This hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF BRIAN K. ATCHINSON, EXECUTIVE DIRECTOR, INSURANCE MARKETPLACE STANDARDS ASSOCIATION

Introduction

Thank you for the opportunity to address the issue of Federal Involvement in the Regulation of the Insurance Industry.

I am Brian Atchinson, Executive Director of the Insurance Marketplace Standards Association (IMSA). IMSA is an independent, non-profit membership organization created in 1996 to strengthen consumer trust and confidence in the marketplace for individually-sold life insurance, annuities and long-term care insurance products. We encourage you to visit our website *(www.IMSAethics.org)* to learn more about IMSA. IMSA members comprise more than 200 of the Nation's top insurance companies representing approximately 65 percent of the life insurance policies written in the United States. The IMSA Board of Directors is comprised of chief executive officers from IMSA qualified companies as well as non-insurance industry directors. To attain IMSA qualification, a life insurance company must demonstrate its commitment to high ethical standards through a rigorous independent assessment process to determine the company's compliance with IMSA's Principles and Code of Ethical Market Conduct.

From 1992–1997, I served for five years as Superintendent of the Maine Bureau of Insurance. In 1996, I was President of the National Association of Insurance Commissioners (NAIC). Prior to joining IMSA, I served as an executive officer in the life insurance industry. As a former regulator and company person, my views on the regulation of insurance are based upon a number of different vantage points.

The Changing Role of Market Conduct Regulation

Insurance regulation is intended to ensure a healthy, competitive marketplace, protect consumers, and create and maintain public trust and confidence in the insurance industry. An integral component of insurance regulation is the appropriate oversight of the manner in which insurance companies distribute their products in the marketplace; namely, market conduct regulation.

The history of market conduct regulation goes back to the early 1970s when the NAIC developed its first handbook for market conduct examinations and did its first market conduct investigation. We've come a long way—by 2001, the states employed 353 market conduct examiners and 103 contract examiners, 815 Complaint Analysts, and 494 Fraud Investigators. In 2001, departments reported a total of 1,163 market conduct exams and 439 combined financial/market conduct exams.

Yet, as noted in the report on market conduct regulation issued by the General Accounting Office last month, there is little uniformity in the manner in which individual states perform market conduct examinations today. Knowledgeable observers agree that the current state-based system of market conduct regulation presents challenges that even many in the regulatory community acknowledge is in need of improvement/updating. State market conduct examinations have been described as being like snowflakes—no two are alike. Insurance companies often are subject to simultaneous or overlapping market conduct examinations from different states applying different laws and regulations. This lack of uniformity places significant costs and human resource burdens upon insurance companies that translate into higher costs which are ultimately passed on to consumers in the form of higher prices for their products.

Making Market Conduct Regulation More Efficient

The challenge going forward is to create a uniform system of market conduct oversight that creates greater efficiencies for insurance companies while maintaining appropriate consumer protections.

The NAIC has been working toward uniform regulation for some time. But, unfortunately, the efforts developed since issuance of the NAIC's Statement of Intent over three years ago have not attained substantial improvements in market conduct reg-

ulation. The pace of change has been slow and has prompted the industry to promote more efficient and effective alternatives.

Establishing Federal standards to regulate the market conduct practices of insurers could improve the current regulatory system in several ways. As the GAO Report indicates, many states do not maintain a formal market conduct analysis or examination process. By introducing a uniform set of national standards for market conduct regulation, consumers could be assured that all insurers would be subject to some degree of regulatory oversight.

Establishing national market conduct standards would allow regulators to focus upon whether an insurer has a sound market conduct and compliance infrastructure in place to better protect consumer interests. Today's market conduct examinations tend to focus upon technical instances of noncompliance rather than exploring whether a company has a comprehensive system of policies and procedures in place to address market conduct compliance issues. Uniform national market conduct standards also would establish a more efficient regulatory process which would eliminate the costs and administrative burdens of the current system that are ultimately passed on to consumers.

Response to Market Conduct Challenges

IMSA's mission is primarily to strengthen trust and confidence in the life insurance industry through commitment to high ethical market conduct standards. IMSA qualification also provides a consistent uniform template of market conduct compliance policies and procedures at all IMSA member companies. To become an IMSA-qualified company, an insurer voluntarily undergoes an internal assessment of their existing policies and procedures to determine whether they comply with IMSA standards. They must then successfully complete a review by an independent assessor to qualify for IMSA membership. By undergoing the independent review required to attain IMSA qualification, a company must have in place a comprehensive system of compliance throughout the organization.

Companies that qualify for IMSA membership devote considerable resources to maintaining IMSA's standards. They also are well-positioned to respond quickly and effectively to state market conduct inquiries and to comply swiftly with new Federal or state legislative requirements.

In the last two years, IMSA has gained greater acceptance by regulators and rating agencies. In fact, a small, but growing, number of state insurance departments use IMSA membership as an informational tool when planning and conducting market conduct exams. We applaud these efforts and would like to see more state insurance departments using IMSA information to create greater efficiencies in the market conduct examination process. A recent study released earlier this year by the research arm of the National Conference of Insurance Legislators (NCOIL) acknowledged the important benefits independent standard-setting organizations such as IMSA can provide to promote sound marketplace practices. During a period of time in which state insurance department budgets are under tremendous pressure, we encourage regulators to pursue all available means to leverage increasingly limited market conduct examination resources.

IMSA continually strives to meet the needs of consumers, companies and the marketplace as a whole by helping its member companies develop and refine an infrastructure of policies and procedures designed not just to detect but to resolve questionable marketing, sales, and distribution practices before they become more widespread.

Consumers should be able to expect honesty, fairness and integrity in their insurance transactions. Neither regulators nor companies alone can ensure that the marketplace is always operating in a fair and appropriate manner at all times. Organizations like IMSA, working in conjunction with regulators, can offer invaluable support to reform market conduct regulation and may even offer a blueprint for uniform, national reform solutions.

Conclusion

The financial services marketplace is becoming increasingly competitive for life insurance companies. To be able to bring products to market and conduct their operations in an efficient manner, the life insurance industry, as represented by IMSA member companies, believes market conduct regulation must be more uniform and efficient. IMSA qualified companies stand as the benchmark for excellence in the life insurance industry and provide a de facto nationwide set of uniform market conduct and compliance standards that can serve as a template for true market regulation reform.

We, at IMSA, will continue to explore ways to improve market conduct regulation for the benefit of regulators, insurers and consumers alike. I would like to thank

the members of this Committee for examining this crucial topic and for the opportunity to share my perspectives on this important issue.

PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES (NAMIC)

Introduction

Mr. Chairman, members of the Committee, the National Association of Mutual Insurance Companies (NAMIC) is pleased to submit this statement for your consideration on the matter of Federal involvement in the regulation of insurance.

NAMIC is the Nation's largest property/casualty insurance trade association with 1,350 members that underwrite more than 40 percent of the p/c insurance premium written in the United States. NAMIC's membership includes 4 of the largest p/c carriers, every size regional and national insurer and hundreds of farm mutual insurance companies.

As you may know, the first successful insurance company formed in the American colonies was actually a mutual: The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. It was created in 1752 after Benjamin Franklin and a group of prominent Philadelphia citizens came together to help insure their properties from fire loss.

In the early days of our nation, most insurance companies followed the Contributionship model; that is, groups of neighbors or business owners formed mutual insurance companies to help each other avoid the certain financial ruin that would befall them if their properties or businesses were destroyed by catastrophic events.

While we honor our history, today's mutual insurance industry also has a clear vision of the future. Insurance regulation should remain close to those who understand the needs and preferences of their constitutencies. The states should continue to regulate the business of insurance however not without significant reforms to incorporate modern day efficiencies. Artificial barriers to competition and regulations that vary from state to state without serving any public purpose make it more difficult than necessary to do business n a regional or national basis.

NAMIC member companies believe that a reformed system of state insurance regulation is superior to an unproven system of Federal regulation. Achieving reform of state insurance regulation is our highest policy priority, and every year, we devote a larger percentage of our resources to achieving this objective. Given the profile of our membership, NAMIC's position is representative of a dynamic cross section of the property/casualty insurance industry.

Because of our official position, NAMIC welcomes this hearing. Not only are we confident that this committee will reach the same judgment as our member companies, we believe that any indication by the Congress of an interest in insurance regulation will motivate state policymakers to act.

The Road to Reform from the NAMIC Perspective

In 2002, NAMIC released a public policy paper articulating our argument against Federal regulation of insurance. Entitled *Regulation of Property/Casualty Insurance: The Road to Reform,* it is the culmination of years of member study. Our member companies began their consideration with an open mind, but as work progressed it became clear that the best option for consumers and the insurance industry is to reform the state system rather than coming to Congress for a solution that promises to be worse than the original problem.

The insurance industry is at a crossroads. Many in our industry already have chosen the path of reform that runs through Washington. They believe the state system of regulation is irreparably broken and only can be fixed by Congressional action. Others take a wait and see approach to reforming the state system. Indeed, they are engaging in efforts of reform, but with one eye on the clock, almost waiting to jump on the bandwagon making the most progress.

Missing from this debate is the point of view that a Federal regulator, or even a dual charter, is not in the best interest of the industry or consumers. It is this point NAMIC emphasizes based on the following reasons:

Federal Involvement is the Wrong Answer at the Wrong Time

In developing our public policy paper, NAMIC identified a series of defects in the rationale for seeking Federal involvement in the regulation of insurance. They include:

1. *Federal involvement is often used to enact social regulation.* Under a Federal system, insurance is likely to be treated as another "government entitlement"

with all the trappings associated with that term. This would cause serious erosion to the basic principles of risk sharing upon which the industry is built.

2. *Asking Congress to intercede is fraught with danger for consumers and industry.* Proponents of Federal regulation may design their idea of "a perfect system," but they can neither anticipate nor prevent the imposition of social regulation in exchange for the new regulatory structure. In our judgment, the chances of the "perfect system" going from draft legislation into law are almost nil.
3. *A Federal or dual charter not only would not reduce regulation, it would add regulatory layers and complexity to the current system.* It is by no means certain that a new Federal regulator would be the "single" regulator for even the largest property/casualty insurance companies. Dual regulation, proposed by some, would produce an unfair environment for the thousands of smaller companies, and create regulatory competition that often produces poor policy in financial institution regulation.
4. *Costs and bureaucracy will increase under a Federal framework.* Will a Federal charter reduce regulatory costs that are indirectly paid by consumers and/or taxpayers, and will it bring about less bureaucracy for companies choosing this option? There is no evidence that a Federal insurance regulator is going to depart from the tradition of creating an expensive and inefficient government program. In addition, each state has its own unique tort laws that significantly affect insurance. Because state tort laws do not constitute the regulation of insurance, and have historically been shown great deference by the courts, federally licensed insurers would have to tailor products to accommodate each state's tort laws. These factors will significantly hamper gaining efficiencies from a Federal system.

   The cost to consumers will inevitably rise as well. Currently, states derive significant income from premium taxes, which exceed the cost of regulation. The cost of a new layer of Federal regulation must be accounted for somehow. The necessary funds must either come directly from the Federal budget, or from fees assessed to insurers. Since taxes and fees must be passed on to consumers, they will have to pay for two regulatory systems under a dual charter approach, unless the states forego premium tax revenue.
5. *When the single national regulator makes a mistake, it has significant economy wide consequences.* When a state regulator makes a mistake, the damage is localized and can be more easily "fixed." In other words, what if a national regulator gets it wrong? Industry proponents argue that Congressional action could produce a national system resembling the open competition found in Illinois—a regulatory model that NAMIC strongly supports. But what if the system created looks more like highly regulated states? The economic fallout from a strict national regulatory climate would be crippling, and the accountability would be at Congress' door.
6. *The time for further change has not arrived.* The new balance necessitated by GLBA is still evolving. It has shown great promise, but requires more time to mature fully. Unlike 1999 when GLBA passed, there is no major impetus, such as convergence of the financial services industry, to further change the balance between Federal and state regulation. In times past, momentous change has been the consequence of significant needs or events. No such need exists today. Change without need could destabilize a system that has worked well throughout our Nation's history.

State Regulation is More Pro-Consumer

From a consumer's perspective, the state system of regulation has performed admirably. It has proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts. Proposals for Federal and dual charters offer few advantages for consumers, and consumer interests are rarely cited as reasons for changing from the state system.

Federal regulation is no better than state regulation in addressing market failures or consumer interests. Regulated industries of all types have had failures at both regulatory levels. Neither can claim immunity from market failure. Additionally, claims that consumers are well served by Federal bureaucracies seem dubious.

The clear advantage to consumers in the state system is accessibility. It is easier for an insurance consumer to deal with a regulator in their home state than having to contact a regional Federal office to intervene in disputes.

A Reformed System of State Insurance Regulation is Superior

Changes must be made to create a reformed, competitive and consistent system that will benefit both consumers and industry. NAMIC is working to achieve four specific areas for state reform:

Rate Regulation

States should eliminate the approval process for pricing insurance products. NAMIC has endorsed the NCOIL Property/Casualty Modernization Act approved in 2001. The model lays out a "use and file" regime for personal lines in competitive markets and a "no file" standard for commercial lines. There is unanimous support among the industry trades for this language.

Still, this is a potentially controversial issue among some state legislators. However, rate modernization not only is not radical, it is not new. Two brief examples speak to its success as public policy:

- In 1969, the *Illinois* legislature repealed outright the prior approval law that was put in place following passage of McCarran-Ferguson in 1945. Property/casualty rates in Illinois remain unregulated today. Several vital signs demonstrate that this policy works well. Today, consumers enjoy stable rates, ranking in the middle of all states in average personal expenditures because the Illinois market attracts the largest share of all private passenger auto and homeowner insurers in the Nation. Low residual markets indicate affordability and availability. These positive signs are all the more remarkable when you consider that Illinois includes the third largest urban area in the United States, and two-thirds of the state's residents live in the Chicago area. With over three decades of success and no legislative proposals to reinstitute regulation, there can be no argument that this structure is well tested and beneficial to everyone involved.
- The demonstrably negative impact of prior approval on *South Carolina's* state auto insurance market prompted the Legislature to act in 1999. Only 78 companies offered policies in the state in 1996 and over 40 percent of all insured drivers were in the assigned risk pool. With the elimination of prior approval in favor of a flex rating system, 105 new companies are in the market, rates are lower and residual market participants, once numbering over a million, have declined to 58,000.

Recent progress demonstrates that states are beginning to take responsibility for the negative results of their regulatory policies. *New Jersey* and *Louisiana,* two of the most restrictively regulated states in the nation, have begun to overhaul their public policies regarding rate regulation in the face of shrinking pools of insurance providers.

As has been often and loudly stated, the product approval process is especially challenging for the life industry because of direct competition with banks in certain financial services. NAMIC agrees that the life industry and its consumers would be well served by a streamlined regulatory process and believe the life compact could help address this need. Efforts to create a more competitive marketplace for insurers and consumers alike must not begin and end on the life side of the equation.

Market Surveillance

States vary widely in how they staff and approach their market surveillance activities. A few states, for example, regularly schedule market conduct exams, regardless of whether problems have been reported with a particular insurer. The open-ended costs of these exams (salaries, meals and lodging) are charged to the company under examination. A lack of uniformity and coordination among states in performing exams often results in duplicative and costly processes, especially for multistate insurers, who are most likely to be targeted for review.

As state insurance departments spend less time on "front end" regulation (*i.e.,* prior approval), states need to adopt a market regulation program that relies on analysis of existing and available market data to reveal performance deviations rather than largely open-ended market conduct examinations relied upon today. With this approach, regulators can focus their limited resources on companies that fall outside a predetermined set of standards developed from data analysis. Any new market regulation process must be proportional, allowing insurers to mitigate complaints or market inconsistencies before being subjected to more severe actions like a market conduct exam, administrative penalty or fine.

Solvency Monitoring

State regulators have adopted several solvency tools over the past decade to strengthen oversight of the insurance industry. While the industry has supported

improvements in solvency monitoring, there remains a high degree of variation among states in how financial exams are conducted. NAMIC has helped produce an industry white paper that identifies three primary recommendations to facilitate discussion of the examination system by all stakeholders. Recommendations under consideration by the NAIC center on controlling expenses, integration of private CPA auditor work and risk-oriented financial reporting.

Company Licensing

States, working through the NAIC, have made some progress in the past few years in bringing more uniformity to the company licensing process. One outcome is the Uniform Certificate of Authority Application (UCAA), which is now used in all insurance jurisdictions. The states should now consider draft language so future amendments to the UCAA can be adopted without seeking legislative approval each time. However, the key to more uniformity of this process is ensuring that state deviations are reduced or eliminated.

Response to S. 1373: The Insurance Consumer Protection Act

One bill the Senate is considering is S. 1373, The Insurance Consumer Protection Act. In our analysis, the legislation brings to life many of the concerns we have about Federal regulation.

Government approval of insurance prices. S. 1373 is an anti-competition bill in that it would require prior approval for all rates by a Federal regulator. Not only is competition a much better regulator of rates than government, regulators in states with prior approval are routinely backlogged in their reviews. One super-agency is unlikely to be capable of staying current with rate applications. The result will be the imposition of needless bureaucracy and less efficiency with national implications.

Massachusetts' repressive auto rating structure provides living proof that restrictive regulation is unnecessary and harmful to insurers and consumers alike. In Massachusetts, the Insurance Commissioner is charged with setting every aspect of the auto insurance rate, even including the amount of money that an insurer may allot to expenses. This rate applies to all companies doing business in Massachusetts, which gives large national insurers who enjoy economies of scale a distinct advantage over smaller insurers. Despite this advantage, these insurers avoid this state. Massachusetts' auto insurance market is in a severe state of decline. Currently, there are less than 20 companies writing auto insurance in the state, while NAIC statistics show that their auto insurance rates are some of the most expensive in the Nation. On May 16, 2003, the Massachusetts Commissioner of Insurance held an annual hearing to determine whether competition existed in their auto insurance market. Had she found in the affirmative, she would not be obligated by state law to set rates as described above. This hearing, which was widely attended by the insurance industry, proved that regional and national insurers would like to re-enter this market. However, they will not do so until this punitive regulatory environment is reformed a change that has been made by other states.

The number of insurers who compete in the competitive Illinois market is at least 6 times the number who seek to survive in Massachusetts. In today's world, harmful regulatory structure has an impact beyond state borders. Many regional and national companies have simply decided that it is too costly to contend with this regulatory relic, so they avoid the state altogether, denying choices to consumers and removing incentives for companies to lower rates. True reform will result in the elimination of unnecessary regulatory burdens.

This proposal promises to slow regulatory processes even more through a provision that would allow anyone to challenge a rate filing. This is a serious flaw, particularly in the absence of provisions prohibiting frivolous or malicious objections. While consumers do not want to pay higher insurance rates, they also want to their insurance carrier to be solvent. Ideally, premium decisions should be based on adequacy of the rate and competitive pressure—not political pressure. Subjecting the critical calculation of ratemaking to a political process, as this provision would, will harm not help consumers by creating a supercharged environment in which defending rates that are actuarially sound will be needlessly difficult. This is the kind of "social regulation" that will ultimately harm this industry's ability to charge a price based on risk.

Increased market conduct burdens. This proposal dramatically increases the use of market conduct examinations. While regulators and industry agree that this can be a useful regulatory tool, the way in which exams are triggered and conducted is already under an extraordinary level of scrutiny. Currently, the states that conduct these exams do so on a scheduled basis-regardless of the company. The result is that a company on solid footing may face an intensive review, while the bad actor

next door knows that they won't be subject to an exam for another 3 or 4 years. Even when bad actors are revealed, regulatory resources will be spread so thin that dealing aggressively with the problem may not be possible. This proposal would radically increase the indiscriminate use of this tool at a time when there is a growing consensus that a more thoughtful, and perhaps targeted, approach is more desirable.

A far more constructive use of regulatory resources is to focus on identifying and intervening in problem situations. Systems to facilitate this more effective form of regulation are currently under consideration. Diverting resources away from identifying and addressing problems in their earliest possible phases can only harm the cause of responsible regulation. Not only would this result in needless use of public and private resources, but also it would be a mistake felt nationally.

Destabilized state guaranty funds. State guaranty funds are one of this industry's greatest consumer protection stories. Their creation and continued success provides further proof of this industry's ability to adapt to the needs of the times. By removing all federally licensed insurers from state guaranty funds, this proposal would leave the viability of the state guaranty funds in question. It is unclear whether the remaining local companies in each state would have sufficient resources to protect consumers whose insurers become insolvent. Once again, this mistake will result in needless bureaucratic duplication, and will be felt on a national basis.

A related and troubling aspect of this proposed legislation would create a Federal guaranty fund system, and protect its officers from personal responsibility, "for any act or omission". This provision is particularly curious in light of the heightened corporate governance provisions in this Act. While CEOs of insurance companies would be required to personally attest to portions of their annual reports, guaranty fund officials are given civil immunity for "any act or omission". This inequity is compounded by what can only be described as the Act's victim-pays provision. If insurers are victims of official misconduct, they will be forced to fund their own compensation for damages, in that repayment will come from the guaranty fund.

Suspect uniformity. One of the few advantages that could potentially be offered by Federal regulation is a degree of uniformity by eliminating unnecessary regulation. However, this proposed legislation would not provide uniformity because it subjects federally licensed insurers to state regulations that are more stringent than the Federal standards.

Not all differences between the states are unnecessary, but reflect unique conditions in each state. For instance, the states are prone to a diverse series of risks that inevitably result in different regulatory requirements. Those risks include: earthquakes, floods, draught, forest fires, hail, tornadoes and hurricanes. The p/c industry provides insurance for natural disasters, and our products must vary to address the particular situation in each region. When it comes to these kinds of differences, one size does not fit all, and a government-sponsored incentive in one area would make no sense in another. These variations will continue regardless of the regulatory structure.

Tort laws will also continue to vary by state. Because tort laws do not appear to constitute the regulation of insurance, and have historically been shown deference by the U.S. Supreme Court, a Federal insurance regulator would not have the authority to create tort uniformity.

Even the sponsor of S. 1373 recognizes the primacy of state law, in the aforementioned provision that subjects federally regulated insurers to state standards that are more restrictive than the Federal standards, unless the state standard prohibits something authorized by the Federal law.

New bureaucracy. It creates a new regulatory bureaucracy, while leaving state systems and premium taxes in place. It is commendable that this proposal does not seek to deny states much needed premium tax revenues in these difficult fiscal times. However, the result will be that policyholders would have to fund two regulatory structures. This is particularly troubling in light of the fact that state systems have a proven ability to adapt to the needs of the times.

The Role of the NAIC in Regulatory Reform

Calls for reform of the state insurance regulatory system have been heard for years but little substantive reform, other than the NAIC financial accreditation program, has occurred. Frustrations have grown as the marketplace becomes more competitive and more global. Complicating matters further is that the NAIC is often—wrongly in our view—held to account for implementation of sweeping reform.

The NAIC is just one piece of the reform puzzle. Public policies defining reform must be established by state legislatures. Yet the NAIC has been looked to for years by Congress and others as the source of regulatory reform.

The first decision by the Supreme Court of the United States on state versus Federal power to regulate insurance was *Paul* v. *Virginia* (1869). The Court held that delivery of an insurance policy in Virginia issued by a New York company was not interstate commerce. The Court employed a narrow definition of "commerce". As a mere contract rather than a physical good or commodity, Congress was not empowered to regulate it.

Two years after *Paul,* the National Convention of Insurance Commissioners (later the NAIC) convened for the first time to help its member regulators oversee companies doing business in one state. Uniformity in legislation affecting insurance and departmental rulings was high on the new organization's list of objectives.

In 1944, the Supreme Court overturned *Paul,* redefining insurance as interstate commerce and triggering passage of the McCarran-Ferguson Act by Congress the following year. Under McCarran, states can preempt Federal anti-trust laws by regulating the business of insurance. The industry and the NAIC were given three years by Congress to devise a regulatory framework that could be put into effect across the country to halt enforcement of Federal anti-trust and discrimination acts.

The NAIC responded by developing model acts and regulations related to insurance rates and policy form language that were quickly enacted by the states. This set of circumstances gave birth to the present regime of prior approval for property-casualty products now operational in more than half the states and opposed by NAMIC today.

In the late 1980s, the House Energy and Commerce Committee's persistence in challenging regulators was instrumental in the NAIC adopting its Financial Regulation Standards and Accreditation Program in 1989. The program consisted of a set of financial regulation standards for state insurance departments, which identified model laws and regulations, and regulatory, personnel and organizational processes and procedures necessary for effective solvency regulation.

Nearly all the states, with the help of their legislatures, subsequently adopted the accreditation standards, but this has not stopped Congress and others from continuing to ask probing questions about the continued viability of the program. As recently as August 2001, a report prepared by the General Accounting Office outlined "gaps and weaknesses" in the accreditation program in response to the Martin Frankel fraud scandal. This, in tum, has caused the NAIC to re-evaluate certain aspects of its accreditation standards.

Clearly, this type of oversight of state insurance regulation seems appropriate for Congress to continue to pursue. It is also important here to mention another "role" that Congress has played with respect to state insurance regulation in the past decade. In 1992, Congress enacted legislation that had the effect of standardizing the Medicare supplemental insurance policies. While Congress mandated this requirement, it was left to the NAIC and the states to "design" the standardized forms and to implement their use in each state.

While this particular piece of legislation appears to have worked well in protecting citizens from purchasing unnecessary multiple Medigap policies, it is not yet clear to us whether this approach would work for other lines of insurance or in possibly bringing more uniformity to certain state regulatory functions.

The Gramm-Leach-Bliley Financial Services Modernization Act (GLBA) contained at least two provisions directly affecting state insurance regulation. The first called on state regulators to develop a better system of licensing out-of-state insurance producers, or face a Congressionally mandated entity to perform that function. Regulators responded with a uniform producer licensing model act and two years' worth of effort enacting it in most state legislatures. The other GLBA provision required insurers to protect the nonpublic personal information of their policyholders. Forty-nine states and the District of Columbia have met the GLBA privacy standards, largely based on the NAIC privacy model.

Taking the intent of GLBA one step farther, regulators agreed to a "Statement of Intent" in March 2000 outlining their desire to change the organizational structure of insurance regulation to better address the rapidly evolving changes to the financial services industry.

This brief review of the NAIC's actions over the years naturally leads to the conclusion that the NAIC is the protector of the principles of insurance regulation in general and state regulation in particular and as such it should be the source of comprehensive reform.

However, in our judgment this is incongruent with reality. In describing its own work, the NAIC has said that regulators have long realized that diversity and experimentation are strengths of the state system, but they also recognize that the basic legislative structure of insurance regulation requires some degree of uniformity throughout the states. This inherent tension between sovereignty and uniformity in the context of a voluntary organization of mostly appointed state officials

with no authority to enact the models they write has produced both large expectations and large disappointments.

The NAIC deserves recognition for focusing attention on key marketplace improvements such as speed-to-market and market conduct for which NAMIC member-companies are asking. Out of necessity, much of their work concerns the procedural or functional aspects of regulation. Unfortunately, by themselves, better procedures do not satisfy the deeper needs of the industry.

While individual state regulators can recommend standards for reform and raise the profile of important market reform issues, they cannot act alone. Simply put: the NAIC cannot be expected to do what it is not empowered to do, that which is the most pressing task for all of us concerned about the future of the insurance industry: enactment of fundamental public policy reform.

In the final analysis, before Congress intercedes, state legislative action must be the focus of modernization initiatives. There are important and effective national organizations prepared to lead reform efforts in the states.

The Role of National Legislative Organizations in Regulatory Reform

NCOIL. The National Council of Insurance Legislators was formed in 1969 to help legislators make informed decisions on insurance issues affecting their constituents and to oppose any encroachments of state authority in regulating insurance.

NCOIL members collectively represent residents in states where 90 percent of insurance premium is written each year. In addition to conducting annual meetings/seminars for its members, NCOIL has been instrumental over the years in developing its own set of model laws that have been enacted in several states. These models have addressed issues such as financial information privacy, mental health parity, life settlements, long-term care tax credits, Federal choice no-fault, commercial lines deregulation and property/casualty domestic violence.

The leadership of NCOIL also has testified at several Congressional hearings in opposition to initiatives that would have created a dual system of insurance regulation, in opposition to Congressional initiatives that would have usurped the existing authority of states to regulate insurance rates, and on the viability of having an interstate compact to govern key aspects of insurance regulation.

ALEC. The American Legislative Exchange Council was founded in 1973 by a small group of bipartisan state legislators with a common commitment to the Jeffersonian principles of individual liberty, limited government, federalism, and free markets. Today, ALEC has grown to become the Nation's largest bipartisan individual membership organization of state legislators, with more than 2,400 members in 50 states.

ALEC remains committed to preserving the state regulation of insurance and has developed its model Property/Casualty Insurance Modernization Act to facilitate the replacement of outmoded, inefficient insurance regulations with market-based reforms. In addition, ALEC has developed a special project, national in scope, designed to educate state lawmakers about the importance of making insurance regulatory changes that are less intrusive and more uniform in nature, which is one of the primary goals of those clamoring for Federal preemption.

One of the most exciting aspects of ALEC's involvement with this issue is its extraordinary record of success in affecting public policy changes in other areas. ALEC, for example, is the preeminent force for state level tort reform efforts facilitated through ALEC's Disorder in the Court Project. ALEC legislators have introduced more than 100 bills in over two-dozen states. Over 20 of these bills have been enacted. Members are also responsible for passing model pension reform legislation in 13 states over the past two years, a monumental success. This leadership is likely to continue. More than 100 ALEC members hold senior leadership positions in their state legislatures, while hundreds more hold important committee leadership positions.

NCSL. The largest state legislative organization is the National Conference of State Legislatures, formed in 1975. The primary component of NCSL's mission is to advise Congress and the Administration as to the effect of Federal action on the states.

Recently, the organization's Executive Committee Task Force to Streamline and Simplify Insurance Regulation approved a Statement of Principles to guide state legislatures in the pursuit of regulatory reform for the property and casualty industry. Also approved was an interstate compact that would facilitate the approval of annuity, life insurance and disability income products by a single entity for use in all insurance jurisdictions. For the NCSL to depart from its Federal advisory function to make specific state proposals is an extraordinary step.

While NCSL has no more power to bind than does the NAIC, there is a fundamental difference in authority. Its members are elected officeholders with obvious influence over the outcome of legislative proposals in the states.

Conclusion

NAMIC joins with our colleagues in asking for fundamental reform of insurance regulation. While we disagree with some on the method to bring this about, we all agree that unnecessary regulatory barriers between the states must be eliminated. True reform must also preserve the meaningful differences between the states. This balance can best be achieved through reforms within the states.

History has proven that state insurance regulation can be reformed through emphasis on state legislatures. In taking this stance, we are not relying solely on history. We have cited significant changes that are currently underway: within the states, at NCSL, NCOIL, and ALEC, and at the NAIC. These changes are happening with the cooperation, assistance, and advocacy of the insurance industry.

At the same time, we are deeply concerned about calls for Federal regulation of insurance. After extensive study, NAMIC has determined that Federal regulation of insurance was undesirable because:

1. It is likely that social regulation would be employed, harming the industry's ability to price risk.
2. There is no guarantee that proven free market reforms would be employed.
3. Any system of dual regulation would add a layer of bureaucracy and cost that would ultimately be paid by policyholders.
4. Regulatory mistakes will not be contained within a single state, but will have an immediate national impact.

When we first articulated these concerns, some argued that they were only theoretical. However, with the introduction of S. 1373, the Insurance Consumer Protection Act of 2003, many, if not all of our concerns have been justified.

The areas for reform have been defined. Now it is up to the states to enact changes in public policy that will make the difference. We urge you to continue your efforts to assure that change takes place in the states. As it has in the past, your interest alone will prompt a renewed resolve on the part of the states. We believe this pressure, given time, will bear fruit.

Thank you for your consideration of our comments.

PREPARED STATEMENT OF THE INDEPENDENT INSURANCE AGENTS & BROKERS OF ARIZONA (IIABA)

Chairman McCain, Ranking Member Hollings, and Members of the Committee. My name is Lanny Hair, and I am pleased to have the opportunity to give you the views of the Independent Insurance Agents & Brokers of Arizona (IIABA) on the current state of insurance regulation and IIABA's views on the role Congress can play to reform and improve the current system. I am the state executive of IIABA, and our association represents approximately 300 agencies in Arizona as well as an additional 100 "Associate" members engaged in support services to independent agencies. It is our membership that is the "front line" communication to insurance consumers, and we feel a strong allegiance and obligation to represent those consumers and their interest in insurance regulatory issues.

Introduction

At the outset, Chairman McCain, I must note that IIABA applauds the Committee's interest in this issue as we have many challenges facing the state-based system of insurance regulation. It is our expectation that this hearing will be the first step in what promises to be a comprehensive and ongoing process, and we hope we will have the opportunity to present our views at each and every stage of your deliberations on these crucial questions.

In the last few years, the perceived need for reform has increased. The enactment of financial services modernization legislation and the emergence of an increasingly more consolidated, more global financial services industry have sparked new interest in the concept of an "optional" Federal insurance charter and, more generally, in Federal regulation of the business of insurance. Proponents of such proposals argue that Federal insurance regulation would promote greater uniformity, reduce costs and cause less frustration than the current multi-state system.

IIABA believes it is essential that all financial institutions be subject to efficient regulatory oversight and that they be able to bring new and more innovative products and services to market quickly to respond to rapidly evolving consumer de-

mands. It is clear that there are deficiencies and inefficiencies that exist today, and there is no doubt that the current state-based regulatory system should be reformed and modernized. At the same time, however, the current system is exceedingly proficient at insuring that insurance consumers—both individuals and businesses—receive the insurance coverage they need and that any claims they may experience are paid. These aspects of the state system are working well, and I have little doubt that this Committee will hear any testimony to the contrary. The optional Federal regulation proposals, however, would displace these well-running components of state regulation as well and, in essence, thereby “throw the baby out with the bathwater.”

IIABA supports state regulation of insurance—for all participants and for all activities in the marketplace. Yet despite this historic and longstanding support, we are not confident that the state system will be able to resolve its problems on its own. In fact, we feel there is a vital role for Congress to play in helping to reform the state regulatory system, and such an effort need not replace or duplicate at the Federal level what is already in place at the state level. We propose that two overarching principles should guide any such efforts in this regard. First, Congress should attempt to fix only those components of the state system that are broken. Second, no actions should be taken that in any way jeopardize the protection of the insurance consumer, which is the fundamental objective of insurance regulation.

Due to our concerns with the current state regulatory system, our national association, the Independent Insurance Agents and Brokers of America (IIABA) has drafted a proposal that addresses many of our concerns. Under the proposal that IIABA has been developing in conjunction with a broad-based group of insurers and insurance producers, these overarching principles would be satisfied through an approach under which—

(1) Every insurer, agent and broker would be subject to only a single—albeit a state—regulator for licensing determinations, solvency regulation, financial audits, corporate transaction reviews and corporate governance requirements;

(2) The procedures under which states review proposed insurance policy forms would be limited to 30 days, and the requirements that apply to rate approvals essentially would be eliminated for any insurance coverage sold in a “competitive” marketplace; and

(3) Although no substantive consumer protection requirements would be eliminated or displaced, incentives for states to create compacts to streamline the market conduct examination process would be provided and limitations would be placed on the ability of state regulators to conduct costly “fishing expedition”-type examinations.

To explain the rationale under girding this approach, I will first offer an overview of both the positive and the negative elements of the current insurance regulatory system. I will then provide a more complete explanation of IIABA’s proposal to address the negative while retaining the positive elements of the current system.

1. The Current State of Insurance Regulation

As the United States Supreme Court has so aptly put it, “[p]erhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States.”[1] “It is practically a necessity to business activity and enterprise.”[2] Insurance serves a broad public interest far beyond its role in business affairs and its protection of a large part of the country’s wealth. It is the essential means by which the “disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired.”[3] Thus, it is “the conception of the lawmaking bodies of the country without exception that the business of insurance so far affects the public welfare as to invoke and require governmental regulation.”[4] Since the inception of the business of insurance in the United States, it is the states that have carried out that essential regulatory task. Today, state insurance departments employ over 11,000 individuals and address hundreds of thousands of consumer complaints and inquiries annually, and they draw on over a century-and-a-half of regulatory experience they endeavor to protect the insurance consumers of this country.

[1] *United States* v. *South-Eastern Underwriters Ass’n,* 322 U.S. 533, 540 (1944).
[2] *German Alliance Ins. Co.* v. *Lewis,* 233 U.S. 389, 415 (1914).
[3] *Id.* at 413.
[4] *Id.* at 412.

These core regulatory tasks of state insurance regulators can essentially be divided into the following eight categories:

(1) Regulation of the coverage parameters of insurance contracts;
(2) Sales practices regulation;
(3) Claims practices regulation;
(4) Claims dispute mediation/resolution;
(5) Claims payment guarantees—state guaranty funds regulation and solvency regulation;
(6) Claims payment guarantees—qualification standards and financial audits;
(7) Insurer licensing, merger review and corporate governance regulation; and
(8) Insurance agent/broker licensing and qualifications to do business regulation.

As a general matter and as explained in more detail below, the regulatory performance of the state system on the first five of the eight categories—all of which directly involve regulation of the interaction between the consumer and the insurer—is superlative. It is only with respect to determining and monitoring insurers, agents, and brokers' qualifications to do business and financial health that the state system has developed the inefficiencies that are now the focal point of the cries for reform.

a. The Positive—Protecting Consumers and Ensuring Claims Are Paid

The goal of all insurance is to protect the purchaser (or their heirs) from calamity. At its most basic level, this means that the consumer purchases an insurance contract and, in exchange for the premium paid for that contract, the consumer receives a promise from the insurance company that they will be compensated for any losses they experience that are covered under that contract. From the consumer perspective, it is imperative that the insurance contract be adequate for their needs and that the insurer actually pay any claims that are made under that contract. In both of these respects, the historical performance of state insurance regulators is impeccable—they ensure that necessary coverage minimums are included in insurance contracts and, perhaps even more importantly, they make sure legitimate claims are paid.

Regulators play two very distinct roles in ensuring that claims are paid. First, they are responsible for guaranteeing that funds are available to pay any and all claims that arise. Despite their best efforts to oversee and audit insurers' financial solvency, insurance companies—like national banks and savings and loans—sometimes fail. The state system of insurer guaranty funds—which are like Federal Deposit Insurance Corporation (FDIC) insurance but for insurance companies instead of banking institutions—works. It has paid out over $11 billion to cover claims asserted against insolvent insurers since they were first created in the mid-1970s, and none of that money has been at taxpayer expense. The Arizona Guaranty Fund has on several occasions been activated to protect Arizona consumers from carrier insolvency, and local access to Arizona Guaranty Fund employees to help the consumer process claims has been most valuable in expediting payment of monies due Arizona consumers.

Second, state regulators play a vital role in mediating disputes that arise on a daily basis between consumers who have submitted claims and insurers who contend that the claims either are illegitimate or are not covered by the insurance policy. The respective bargaining positions between tens of millions of insureds—such as individuals and small businesses—and their insurers is tremendously skewed. Insurance consumers therefore regularly rely on the intervention of state regulators on their behalf when claims disputes arise. Large segments of every insurance department in the country are dedicated to assisting with the resolution of such disputes, and all available evidence suggests that insurance consumers are very satisfied with those local efforts. The Arizona Department of Insurance is staffed with insurance professionals and attorneys that are recognized as consumer advocates, individuals ready and waiting to become involved in the claims process to assure that the consumer is treated fairly and receives benefits they are due.

b. The Negative—Product Regulation and Duplicative Oversight

It has become evident that all of the perceived shortcomings of state regulation of insurance fall into two primary categories—it simply takes too long to get a new insurance product to market, and there is unnecessary duplicative regulatory oversight in the licensing and post-licensure auditing process.

In many ways, the "speed-to-market" issue is the most pressing and the most vexing from both a consumer and an agent/broker perspective because we all want ac-

cess to new and innovative products that respond to identified needs. The reality of today's marketplace is that banking institutions and securities firms are able to develop and market new and more innovative products and services quickly, while insurance companies are hampered by lengthy and complicated filing and approval requirements in 50 states. As a result, some argue that insurance companies—and, derivatively, agents and brokers selling their products and services—are at a competitive disadvantage compared to their counterparts in other financial services industries.

Today, insurance rates and policy forms are subject to some form of regulatory review in nearly every state, and the manner in which rates and forms are approved and otherwise regulated can differ dramatically from state to state and from one insurance line to the next. While most insurance codes provide that policy rates shall not be inadequate, excessive or unfairly discriminatory, and that policy forms must comply with state laws, promote fairness, and be in the public interest, there are a multitude of ways in which states currently regulate rates and forms. These systems include prior-approval, flex-rating, file-and-use, use-and-file, competitive-rating and self-certification. These requirements are important because they not only affect the products and prices that can be implemented, but also the timing of product and rate changes in today's competitive and dynamic marketplace.

The current system, which may involve seeking approval for a new product or service in up to 55 different jurisdictions, is too often inefficient, paper intensive, time-consuming, arbitrary and inconsistent with the advance of technology and regulatory reforms made in other industries. In recent years, the Arizona Legislature has recognized the need for reform in that area, and has been proactive in "deregulation" of rates and form approval for commercial insurance, as they recognize that segment is comprised of a more sophisticated group of buyers of consumers. However, as you have heard previously, it often takes two years or more to obtain regulatory approval to bring some new insurance products to market on a national basis. Cumbersome inefficiencies create opportunity costs, and the regulatory regime in many states is likely responsible for driving many consumers into alternative markets mechanisms. As a result, the costs of insurance regulation are exceeding what is necessary to protect the public, particularly in the area of commercial insurance. In order to keep insurers competitive with other financial services entities and maximize consumer choice in terms of the range of products available to them, changes and improvements are needed.

Similarly, insurers are required to be licensed in every state in which they offer insurance products, and the regulators in those states have an independent right to determine whether an insurer should be licensed, to audit its financial solvency and market-conduct practices, to review mergers and acquisitions, and to dictate how the insurer should be governed. With the exception of market-conduct examinations, it is difficult to discern how the great cost of this duplicative regulatory oversight is justified, especially in light of the fact that the underlying solvency requirements are essentially identical from state to state. Market conduct examinations present a somewhat more thorny issue because, although the majority of sales and claims practices requirements and prohibitions are similar across the country, there are local variations. It is, of course, difficult for a regulator to determine compliance with another jurisdiction's requirements. At the same time, it seems wholly unnecessary for each regulator to examine every insurer on every aspect of their compliance practices given that there is such an extensive overlap in requirements. The Arizona Department of Insurance recognized the need for reform in this area, and earlier this year streamlined their market conduct examination process with the objective to target those insurance companies which have provided cause to believe are in violation of State Statute or regulatory process. The new procedures will reduce costs and better direct the State's resources to protect the consumer.

2. Solutions

Although heroic efforts have been made to date, state regulators and legislators face the near impossible challenge of addressing and remedying the identified deficiencies unilaterally. For the most part, these reforms must be made by statute, and state lawmakers face practical and political hurdles and collective action challenges in their pursuit of such improvements on a national basis. Despite the actions of the states on producer licensing reform over the last two legislative sessions, real-world realities suggest that it is extraordinarily difficult, if not impossible, to pass identical bills through the 50 state legislatures.

Although the proposed optional Federal regulation proposals might correct certain deficiencies, the cost is incredibly high. The new regulator would serve to add to the overall regulatory infrastructure—especially for agents and brokers selling on behalf of both state and federally regulated insurers—and undermine sound aspects of the

current state regulatory regime. The best characteristics of the current state system from the consumer perspective would be lost if some insurers were able to escape state regulation completely in favor of wholesale Federal regulation. Federal models propose to charge a distant and likely highly politicized Federal regulator with the implementation and enforcement of a single set of rules that would apply equally across all states and all insurance markets. Such a distant Federal regulator may be completely unable to respond to insurance consumer claims concerns and its mere creation could spark fears that this will prove to be the case. Nor can a single regulatory system harmonize the diversity of underlying state reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation. Arizona has a long and proud history of successful State regulation that demonstrates that the unique needs of Arizona consumers have been addressed. The large populations of retired and/or elderly citizens have required that consumer safeguards for this group be put in place, and both the Arizona Legislature and Arizona Department of Insurance accomplished that in a rapid and effective manner. The potential responsiveness of a Federal regulator to both industry and consumer needs in several critical areas could therefore jeopardize the fundamental purpose of insurance regulation and must be considered questionable at best.

This year, Sen. Fritz Hollings (D–S.C.) has introduced the Insurance Consumer Protection Act (S. 1373). This legislation takes a very dramatic approach by proposing to repeal the McCarran-Ferguson Act. In addition, S. 1373 would create a "Federal Insurance Commission," an independent panel within the Department of Commerce. The commission would be the sole regulator of all interstate insurers offering property and casualty insurance as well as life insurance. As with any proposal that would shift regulation from the states to the Federal government, IIABA strongly opposes this legislation.

There are several key components to S. 1373 that IIABA strongly objects to. Under this legislation, a newly formed commission would have full authority over both rates and policies, while at the same time allowing consumers to have a right to challenge rate applications before the Commission. The Commission would also be responsible for licensing and standards for the insurance industry, annual examinations and solvency reviews, investigation of market conduct, and the establishment of accounting standards. The bill would also allow the Commission to investigate the organization, business, conduct, practices and management of "any person, partnership or corporation in the insurance industry." It would appear that insurance agents and brokers would fall under this definition. IIABA believes that by creating this commission, S.1373, would only take everything that is wrong with the current state system and shift it to the Federal level, where there is even less accountability. We are specifically troubled that this legislation would regulate agents from all states and for all lines of business who do business across a state line in what will inevitably be a new massive Washington bureaucracy. While IIABA does have problems with the current multi-state licensing system, we think that adding another layer of regulation on top of this is a big problem.

We believe that the states are better positioned to accommodate diversity and to respond to change. Certainly history shows that the State of Arizona has done an outstanding job responding to needed consumer protections. However, weaknesses exist in state regulation today. Unnecessary distinctions among the states and inconsistencies within the states thwart competition, reduce predictability and add unnecessary expenses to the cost of doing business. Similarly, outdated rules and practices do not serve the goals of regulation in today's financial services marketplace. Nevertheless and as noted previously, there is much that is good about the current state-based system that would be jettisoned through the creation of a Federal regulator, including an enforcement infrastructure upon which consumers throughout the Nation heavily rely to protect their interests. Federal charters and the establishment of a full-blown, unprecedented, untested and likely politicized regulatory structure at the Federal level are not the answer.

What is needed is a third way—a system that builds on, rather than dismantles, the States' inherent strengths to meet the challenges of a rapidly changing insurance environment. It must include mechanisms to promote the establishment of more uniform and consistent regulations and regulatory procedures, but must be poised to respond faster and more fully to the reality of electronic distribution and to emerging industry trends such as globalization and consolidation. It must modernize areas in which existing requirements or procedures are outdated, while continuing to impose effective regulatory oversight and necessary consumer protections. The result, for all stakeholders, should be a more efficient, modernized and *workable* system of insurance regulation.

For the last year, IIABA has been spearheading a cooperative attempt to develop just such a proposal. We have been working with other trade associations and directly with an array of national and regional insurers in an effort to identify precisely what must be fixed and how that might be done without displacing the components of the current system that work so well and without creating additional layers of government bureaucracy. Through this process, four specific areas for reform and the constraints on the mechanisms for that reform have been identified, and we have begun assembling a draft proposal for accomplishing these reforms. In my remaining testimony, I will outline the four components of this draft proposal.

a. Rate and Form Filing and Review/"Speed to Market" Reform

As previously discussed, the product regulation requirements in most states require insurers to file new rates and forms with the insurance commissioner and obtain formal regulatory approval before introducing them in the marketplace. Accordingly, an insurer that wishes to introduce a new product on a national basis may be forced to seek approval in up to 55 different jurisdictions. The process can be inefficient, paper intensive, time-consuming, arbitrary and inconsistent with the advance of technology and the regulatory reforms made in other industries. These cumbersome inefficiencies create unnecessary costs and delays, reduce industry responsiveness and drive many consumers into alternative market mechanisms. The regulatory regime in many states exceeds, in terms of scope and cost, what is necessary to protect the public.

In evaluating potential solutions to these problems, it is essential to recognize that uniformity is very difficult to achieve for property and casualty lines product regulation. Due to geography and other factors, some states must take into account issues that other states need not address. In addition, states may subject rates and forms to different levels of regulatory scrutiny, and as in Arizona personal lines and commercial lines products may be treated differently.

Unnecessary or unreasonable consumer protection concerns also limit the range of potential options to some extent. The concern is that the quicker and easier it is to have a new product or rate approved, the less protection consumers will receive. The solution thus must strike a balance between timely and quality reviews and appropriate consumer protections. In addition, "race to the bottom" and "turf" concerns have to be taken into account. Particularly under a scheme that employs a single point of review, states that use more stringent rate and form processes will be hesitant to accept the introduction of products or policies approved under more lenient guidelines. We believe it is possible, however, to strike an appropriate balance between realizing meaningful speed-to-market reform and protecting consumer interests.

Based on these objectives and considerations, the IIABA proposal is designed to do three things: (1) make the system more market-oriented; (2) make the system faster; and (3) create greater accountability. On the *form approval* side of the equation, this would be accomplished by preempting any state law that requires more than allowing all proposed forms (both commercial and personal lines) to be used no later than 30 days after they have been filed with the insurance commissioner unless the rate or form is disapproved within that time period. Under such a system, an insurer must at most file a proposed form with the insurance department 30 days in advance of the proposed effective date, and the form must be used at that time unless affirmatively disapproved by the regulator. If a department affirmatively approves the filing at any time within the 30-day period, the insurer may use the form immediately. Under the proposal, regulators would be entitled to a single 15-day extension of this disapproval period if an approval application is incomplete, and more permissive state filing/approval requirements would not be affected.

Under this approach, the current requirement that filings be done in every state in which the product will be offered would not be disrupted and current state form requirements would not be preempted (except as discussed below). In both the personal and commercial lines context, any disapproval must be articulated in writing and be based substantively on a properly promulgated statute, regulation or final court order. Many regulators have historically disapproved policy forms based on unpublished and unsubstantiated "desk drawer rules," but such actions would be impermissible under our approach. As noted previsously, more permissive form filing and approval requirements would not be displaced by the Federal rules.

Under our draft proposal, *rate approval* is treated much differently than form approval because the competitive market generally is the most efficient and effective regulator for rates. At the same time, in markets that are not sufficiently competitive, regulators need to retain the ability to monitor rates and to intervene to disapprove rates when necessary. Accordingly, under the draft proposal, any regulatory review requirement for rates in competitive markets that requires more than the

filing of the rates with the insurance department would be preempted. States, however, will remain empowered to approve or disapprove rates in "non-competitive" markets if an affirmative finding has been made determining that the market is "non-competitive." That determination would be subject to Federal court scrutiny under the proposal.

b. Producer Licensing

Insurance agents and brokers must be licensed in every state in which they conduct business, and many producers face considerable hurdles in complying with inconsistent, duplicative and unnecessary licensing requirements when they operate on a multi-state basis. Although state licensing reforms adopted over the last two years offer great promise, additional improvements and refinements are necessary. The core proposal that we are developing to address this problem is to mandate licensing reciprocity in all states and thus achieve meaningful licensing reform that is national in scope. This could be accomplished by prohibiting a state in which an agent or broker is seeking to be licensed on a non-resident basis from imposing any licensure requirement on that person other than submission of proof of licensure in their home state and the requisite fee. Under a reciprocal licensing system that is national in scope, any individual agent or broker would only be confronted by a single set of licensing requirements.

The largest potential impediment to such a proposal is the concern by some that it could create incentives for certain states to establish lenient requirements with the hope that producers might flock there for resident licenses. Such a "race to the bottom" would be detrimental to the goal of fair, responsible regulation. To address the concern, the draft proposal would empower the NAIC to establish minimum standards for licensure. Only agents or brokers licensed as a resident in states that satisfy these minimum standards would be able to benefit from the preemption of state licensing authority over non-resident agents. If an agent or broker resides in a state that does not adopt the minimum-licensing standards, the proposal would explicitly enable that producer to apply to a state in which they do business and that has adopted such minimum standards to be licensed as a resident. Through this mechanism, Congress also could dictate minimum licensing standards. Under the draft proposal, for example, the minimum licensing standards would be required to include the performance of a criminal background check, utilization of standardized licensing cycles and application forms and fees in the filing process, imposition of a standardized trust account requirement for use in any state that requires maintenance of such accounts, and the mandatory availability of agency-level licenses.

c. Company Licensing/Transaction Review/Corporate Governance/Insolvency Standards/Financial Audits

Like insurance agents and brokers, insurers currently must be licensed by every state in which they do business. They also must satisfy a variety of corporate organization, solvency and governance requirements and go through multiple reviews of proposed corporate transactions (*i.e.,* change in control, mergers and acquisitions) and financial audits. Insurers need a single set of requirements; requisite compliance with the rules of multiple states creates delays and adds unnecessary costs without adding any tangible consumer benefit. Compliance with multiple audit procedures also is needlessly inefficient, costly and administratively cumbersome for insurers.

As in the insurance producer context, in developing potential solutions, the possibility of a race to the bottom and regulatory turf concerns of state insurance departments must be considered. In particular, state insurance departments likely will be hesitant to accept licensing, solvency and auditing determinations made by other states where the insurer does a significant amount of business in their states.

Regulation in this area also must contemplate the financial risks at stake if insurer solvency is not sufficiently regulated and companies become financially unsound. Concerns about possible strains on the guaranty system and the need for bailouts (such as in the savings-and loan-crisis) are never far from the surface when dealing with this area of regulation.

To remove duplicative and inconsistent requirements and examination procedures while at the same time maintaining sufficient protection for policyholders and the public, the proposal for companies tracks the producer licensing proposal by preempting the ability of all states to impose any licensing/transaction, review/corporate or governance/solvency standards or requirements on any non-resident company that is licensed by a state that is accredited by the NAIC. An insurer would be able to select as its "home state" either its state of domicile or its state of incorporation. States still would be free to require non-resident companies to be licensed but only upon proof of home-state licensure and the submission of a fee. The draft

will clarify that any company that satisfies such Federal "passport" requirements can offer products in a non-resident state even if the state does not try to license them through the federally approved process (if the state does license in a federally permissible way, an insurer would have to comply with the state requirements, however). Hence, although any state could impose more stringent requirements on its resident companies, the system would remain uniform from the perspective of each individual insurer because each insurer would need to comply with only one set of substantive requirements.

To stem a potential "race to the bottom," a company will be required to be licensed in an "accredited" state in order to use its license as a passport to do business in other states and have the preemption outlined above apply to its activities in those non-resident states. The legislation would empower the NAIC to continue to conduct the accreditation process, subject to two new requirements.

First, additional accreditation requirements would have to be incorporated into the NAIC's accreditation requirements, including the new producer licensing minimum standards and any company minimum licensing, solvency or other standards that Congress chose to incorporate.

Second, the NAIC's accreditation criteria and any determination that a state is (or is not) accredited would be subject to review and disapproval either by a Federal agency or by a Federal court. Such oversight would be limited to reviewing NAIC determinations regarding what standards must be satisfied to become accredited and applications of those standards to states that have applied for accreditation.

To ensure that no company would be penalized (and thus unable to qualify for the "passport" rights) by virtue of the fact that it is domiciled in a non-accredited state, the legislation would permit an insurer to choose an alternative state of "residence" for licensing purposes if its state of domicile and its state of incorporation both are not accredited. Tentatively, the legislation will allow such an insurer to be licensed in the accredited state in which it does the most business based on premium volume. This should increase the pressure on all states to become accredited.

The legislation also must account for the possibility that the NAIC will refuse to implement the program and/or that the states will decide to boycott the process. In either event, the legislation will incorporate the back-up provisions included in NARAB. Hence, either if the NAIC refuses to implement the accreditation procedures as required under the Act or if a majority of states do not become accredited within a specified number of years, an independent body would be established either to stand in the shoes of the NAIC in conducting the accreditation process or—if states refuse to comply—to act as a licensing clearinghouse so that insurers will qualify for the licensing/solvency/etc. single set of requirements envisioned under the overarching approach. The proposal utilizes a combination of the NARAB back-up provisions and the Risk Retention Act non-resident state regulatory provisions to create these fall-back sets of provisions. The tighter they are designed, the less likely it is that the NAIC and/or the states will refuse to comply with the intended NAIC accreditation procedures.

d. Market Conduct Examinations

Insurers are subject to examinations from insurance departments in multiple States. Exam procedures are inefficient and requirements are duplicative as a result of lack of coordination between States. Multiple exams are costly and administratively cumbersome for insurers. There often does not appear to be a sound justification for the examination and there are no restrictions on most insurance department's exercise of their market conduct examination power. As stated earlier, the Arizona Department made major reforms in its Market Conduct Examination procedures this year. Not all states, however, have shared our motivation to improve this aspect of the regulatory process.

It must be noted that market conduct examinations directly involve consumer protection issues and, as a result, turf concerns and political concerns can be prevalent. Moreover, the focus of market conduct examinations is supposed to be on sales practices that occur where the customer is located rather than where the company resides, undermining the practicality of mandating a home-state regulation approach.

To reduce the administrative costs of compliance by clarifying the circumstances under which a regulator of a non-resident insurer may conduct examinations, the frequency with which such examinations may be conducted, and the review procedures that will apply, the proposal would require that, in the non-resident state, examinations may be conducted only to review compliance with properly promulgated statutory and regulatory requirements, and that no insurer can be deemed to have "failed" such an examination unless it is provided with an explanation in writing that sets forth the statutory and/or regulatory requirement that allegedly has been

violated. The proposal includes a provision permitting any claim that a regulator is exceeding the scope of his or her authority to be brought in Federal court.

In an effort to facilitate greater coordination of market conduct examinations where appropriate, the proposal includes a provision authorizing and encouraging the use of multi-state compacts to facilitate market conduct examinations.

Conclusion

Although IIABA supports the preservation of state regulation of the business of insurance, we believe that reforms to the current system are necessary and essential. Specifically, IIABA believes the best alternative for addressing the current deficiencies in the state-based regulatory system is a pragmatic, middle-ground approach that utilizes Federal legislative tools to foster a more uniform system and to streamline the regulatory oversight process at the state level. By using Federal legislative action to overcome the structural impediments to reform at the state level, we can improve rather than replace the current state-based system and in the process promote a more efficient and effective regulatory framework.

Rather than employ a one-size-fits-all regulatory approach, a variety of legislative tools could be employed on an issue-by-issue basis to take into account the realities of today's marketplace and to achieve the same level of overall reform as the imposition of a Federal regulator. State regulation in Arizona has proven to be effective and responsive to Arizona consumer needs. Arizona consumers wish to maintain their say in how insurance regulation protects them. Arizonans prefer to be regulated by Arizonans. The specific ideas outlined above are just a few of the many specific solutions that could be adopted under this type of approach. Instead of relying on the agenda of a displaced and possibly politicized Federal regulator, however, insurance regulation would continue to be grounded on a more solid foundation—the century-and-one-half worth of skills and experience that the states have as regulators of the insurance industry. The advantage of this approach is that it offers the best of all worlds. It will promote the establishment of more uniform standards and streamlined procedures from state to state, protect consumers while enhancing marketplace responsiveness, and emphasize that the primary goals of insurance regulation can best be met by improving, not abandoning, the state-based system that has been in place for over 150 years.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO CRAIG A. BARRINGTON

Question 1. In your testimony, you provide arguments in support of an optional Federal system of chartering insurance companies. You identify many benefits of such a system, in which insurance companies would have the option of remaining subject to state regulation, or of becoming federally-chartered. In addition, you suggest that policy-makers at the Federal level should act to create a more market-based system of regulating insurance companies, to reduce obstacles and allow companies to provide more efficient services and products. If insurance companies were able to move to a market in which rates and prices were more market-based, rather than strictly regulated by government entities, what would be the primary consumer protections that currently exist, or that you would recommend, to ensure that insurance providers, in their desire to provide the best price to beat competition, did not "over-sell" themselves and their products and thereby increase the risk of insurance providers having insufficient resources to satisfy claims?

Answer. Our Optional Federal Charter ("OFC") proposal incorporates strong consumer protection provisions, including national regulatory oversight of financial solvency and market conduct, thus establishing a new national regulatory system designed to detect significant financial issues and multi-state patterns of market misconduct much more effectively than is possible under the current fragmented state approach. In fact, our OFC proposal enhances consumer protection by focusing Federal regulators on those core financial and market behavior oversight functions, rather than on the "government price controls" and "product creativity hostility" that are the twin hallmarks of state regulation in most states most of the time.

However, it is important to note in this regard, that within the general pattern of state price controls, there are some noteworthy exceptions. Your question assumes that insurers are strictly price-regulated for all products in every state today. This is not uniformly the case. In Illinois, for example, there are no government price controls, and market-based rate regulation has worked to create a stable insurance environment for consumers. The Illinois experience substantiates that consumers are well-served by a system where the market sets prices rather than the Illinois insurance regulator setting them. Moreover, there are *no* government price

controls whatsoever with regard to life insurance products, and there is no evidence that free market pricing has resulted in diminished consumer protection for these lines. It is neither good economics nor effective government policy to believe that the financial responsibility of an insurer will in any way be assured through government price controls. Indeed, to the contrary, financial responsibility is protected through a regulatory system that focuses specifically on the financial examination and marketplace conduct of companies operating in that marketplace. This is what our OFC proposal contemplates.

As a matter of general background, insurance regulation today can be categorized in two broad ways. The first approach focuses on government price and product controls that require companies to file insurance rates and policy forms with state regulators and get their approval. The second type of regulatory approach focuses on the financial health and stability of insurance companies—so they can keep the promises they make—and emphasizes oversight of the market behavior of those companies. The former mode of regulation—a government "command-and-control" system—has been discarded for every other major industry except property and casualty insurance. There is no economic justification for its continuation. More importantly, government price and product controls actually deny consumers the kind of marketplace options they enjoy with respect to other products. This type of regulation makes the state regulatory agency the focus of political power, forcing companies to essentially beg the government for approval of prices and products. Regulatory delays in reviewing insurance rates and forms, coupled with reluctance to approve rate increases where necessary or to approve new or innovative products, provides a disincentive for insurance companies to develop a broad range of products. In turn, this hurts consumers by shifting attention away from financial solvency and marketplace regulation, which are the two core "consumer protection" functions of regulators. Government price and product controls create an unhealthy marketplace that relies on government approval, not on consumer demand.

The latter kind of regulation—based on financial health and market conduct—is utilized for every other industry. Focusing regulatory resources on the financial health of those companies operating in the marketplace protects consumers by ensuring that the companies have the financial strength to pay claims when due. Allowing marketplace forces to regulate insurance prices and products empowers consumers, rather than regulators. Regulatory reform (especially elimination of government price and product controls) frees up government resources and allows a redirection of regulatory attention where it is most needed, including effective solvency regulation and rehabilitation or liquidation of troubled companies. Ultimately, consumers also benefit from a streamlined and efficient insurance regulatory system that reduces regulatory costs for insurers.

Question 2. You testified that one possible benefit of a Federal regulatory regime would be the increased speed with which insurance products could be brought to market. Reflecting upon the testimony of Mr. Hunter, I am compelled to echo his question as to what benefit consumers might draw from the increased rapidity in which insurance providers could bring insurance products to market? Wouldn't such rapidity increase the chance that a product could be sold which contained unnecessary risks for consumers?

Answer. AIA advocates removing burdensome, and economically indefensible, impediments to bringing safe new products to market. We do not think there is any justification for this type of system—a system that not only wastes resources, but places such a high barrier to bringing new products to market that it stifles innovation.

Subsequent to the Senate Commerce, Science and Transportation Committee hearing, the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee held a hearing at which Neal Wolin, Executive Vice President and General Counsel of The Hartford Financial Services Group, testified. The following quotes from his November 5 written testimony are instructive of the state regulatory problems experienced by our industry:

> "To give you a sense of impact on our operations, our property-casualty companies make an average of 5,500 filings each year with the 51 jurisdictions . . . and [those filings] often result in lengthy dialogue between our lawyers and actuaries and insurance department personnel. If significant changes are made in one jurisdiction, we may need to restart the process with jurisdictions that have already approved the forms."

> "This elaborate process is burdensome on our industry, but more importantly, has negative effects on the customers we seek to serve. First, consumers ultimately pay the cost of our compliance with this regulatory scheme through higher premiums. Second, the complexity of the process interferes with our abil-

ity to get new products to consumers rapidly. We live in a time when consumer preferences change rapidly, and when industries are generally judged by their ability to discern and meet these changing preferences. In contrast, it can easily take more than a year in our industry to secure the approvals necessary to market a new product nationally."

The magnitude of the problem becomes even more astounding when you consider the aggregate number of property-casualty filings made each year. The volume of submissions, in addition to entrenched hostility toward innovative new products and/or enhancements, diverts regulatory attention. Our OFC proposal emphasizes strong market conduct and financial regulation by the Federal regulator and does not displace mandatory coverage provisions of state reparations laws; these are the principal mechanisms for making certain insurers conduct their business appropriately and for highlighting to the regulator problematic behavior across jurisdictional lines.

If the insurance industry cannot keep pace and cannot provide consumers with real choices, the economy suffers. Insurance provides much-needed security for businesses and individuals to innovate, invest and take on risk. But the ability to innovate, invest and take on risk is substantially impeded because insurers labor under the weight of a "government-first, market-second" regulatory system. It rewards inefficient market behavior, subsidizes high risks and masks underlying problems that lead to rising insurance costs. The bottom line is that consumers ultimately will pay more for less adequate risk protection than would be the case under a more dynamic, market-oriented regulatory system administered by a single Federal regulator.

In summary, this question is closely linked to your first one. AlA's response there aims to address your concerns about regulator review and consumer protection. We obviously do not advocate that new products violate the law. In fact, to reiterate, not only does our OFC proposal preserve and enhance consumer protections, but the jurisdictions that today do not provide price obstacles show no evidence of placing consumers at higher risk. Indeed, the opposite is true: presently the state regulatory system spends the majority of its time, energy, and scarce resources preventing all but the most standard insurance policy forms from getting to the marketplace, instead of monitoring the financial health and marketplace activities of insurers. Consumers would be well-served by regulatory focus on those activities.

Question 3. The American Insurance Association's ("AlA") proposal for an optional Federal charter would apparently leave the insurance guaranty funds at the state level, where they are now. It seems that, taking an example from the Federal insurance for banking deposits, there might be certain benefits to the federalization of large guaranty funds that exist, in part, to reassure consumers and provide confidence that the insurance system as a whole can weather difficulties in certain regions or within certain companies. What are your thoughts regarding the positive and negative aspects of increased Federal participation in the guaranty funds held to protect against insolvencies? Would Federal participation in the guaranty funds reduce the possibility that insurance consumers in one state might be reimbursed at levels lower than other consumers in other states, and, if so, would this result be sufficient, in your opinion, to justify establishing Federal guaranty funds to replace state guaranty funds?

Answer. This is an important question. Although there is a reasonable argument that a Federal guaranty system should be created for federally-chartered insurers, we drafted our OFC proposal-after substantial thought on the issue-to leave the state guaranty fund system in place so long as those state funds provide nondiscriminatory coverage for federally-chartered insurers.

In crafting the OFC proposal, we decided to leave the state guaranty funds in place for a number of key reasons. First, we believe the state guaranty fund system has admirably performed its responsibilities for more than three decades and it may be best not to uproot a system that has had a successful history. Second, we were told by advocates of the state guaranty fund system that, by removing federally-chartered insurers, the state fund system may be weakened, given it would have fewer participating insurers, and ultimately may be threatened. While we strongly believe insurers should have the option to be federally chartered, we do not want to encourage arguments that the OFC proposal impairs elements essential to the state system.

Nevertheless, the state guaranty fund system is under significant stress today based on the recent increase in insurer insolvencies. An ultimate decision about their proper role in an OFC environment is ultimately a matter of thorough legislative debate and discussion. Our current OFC proposal was crafted with a goal of not needlessly disrupting state based institutions and sources of funding.

RESPONSE TO WRITTEN QUESTION SUBMITTED BY HON. OLYMPIA J. SNOWE TO J. ROBERT HUNTER

Question. As we seek to achieve the proper balance between state and Federal regulation of insurance companies, the need to protect consumers' interests is of paramount importance. As such, we need to weigh the value of protecting consumers against abusive practices, as well as the desire to allow consumers to obtain the best prices possible for products, stemming from free competition among insurance providers and the absence of overly burdensome regulations. What are the primary concerns and complaints that consumers raise regarding the provision of insurance? What lessons regarding insurance regulation do these concerns provide?

Answer. Thank you for your thoughtful question, Senator Snowe.

There are three main areas of concern for insurance products—policy forms, risk classifications and overall rate levels. Market forces will not protect consumers on policy forms and risk classifications (such as introducing credit scoring to rate policies). If unregulated in these two areas, insurers are in an overwhelming position to take advantage of consumers. There must be prior approval of policy forms and risk classifications. The issue of risk classification must command more scrutiny by legislators and regulators. Insurers are using all sorts of personal information—completely unrelated to the insurance transaction—to segment the market into smaller and smaller pieces. These actions are undermining the basic principles and policy goals of insurance.

If these two areas—policy forms and risk classifications—are effectively regulated, then an argument can be made that market forces will constrain overall price levels in most lines of insurance (there are exceptions, such as non-competitive lines like assigned risk plans and lines with reverse competition, such as credit insurance). Insurers point to Illinois to support their case for complete deregulation. But consumers point to massive rate hikes in homeowners insurance in unregulated Texas, the worker comp rate explosion in unregulated California and other failures of deregulation to make their case. At best, the evidence is mixed about the role of market forces in regulating overall insurance price levels. Theoretically, then, a file and use system for overall rate levels—combined with prior approval of policy forms and risk classifications—might best balance consumer protections with reliance on market forces.

However, CFA's analysis of regulatory methods throughout the nation, including the file and use systems, concluded that the California auto insurance system—installed as the result of California residents voting for Proposition 103—is the best system for consumers and insurers alike. This analysis can be found at *www.consumerfed.org.* (The report is called "Why Not The Best? The Most Effective Auto Insurance Regulation in the Nation," dated 06/06/01.) Under this system (used for most of property-casualty insurance, but not workers' compensation), competition is maximized by eliminating the state anti-trust law exemption, allowing banks to compete with insurers, removing state impediments to competition, such as anti-group and anti rebate laws, and improving consumer information. It also uses regulation to backstop the competitive forces, understanding that regulation and competition both seek the same goal: the lowest possible price consistent with a fair return for the service providers.

As I point out in my testimony, insurers realized very nice profits, above the national average, while consumers saw the average price for auto insurance drop from \$747.97 in 1989, the year Proposition 103 was implemented, to \$717.98 in 1998. Meanwhile, the average premium rose nationally from \$551.95 in 1989 to \$704.32 in 1998. California's rank dropped from the third costliest state to the 20th.

Updating this information through 2001 [1] shows that, as of2001, the average annual premium in California was \$688.89 (Rank 23) vs. \$717.70 for the Nation. So, from the time California went from reliance simply on competition as insurers envisioned it to full competition and regulation, the average auto rate fell by 7.9 percent while the national average rose by 30.0 percent.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO DOUGLAS HELLER

As we seek to achieve the proper balance between state and Federal regulation of insurance companies, the need to protect consumers' interests is of paramount importance. As such, we need to weigh the value of protecting consumers against

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[1] State Average Expenditures & Premiums for Personal Automobile Insurance in 2001, NAIC, July 2003.

abusive practices, as well as the desire to allow consumers to obtain the best prices possible for products, stemming from free competition among insurance providers and the absence of overly burdensome regulations. What are the primary concerns and complaints that consumers raise regarding the provision of insurance? What lessons regarding insurance regulation do these concerns provide?

Question 1. What are the primary concerns and complaints that consumers raise regarding the provision of insurance?

Answer. For more than fifteen years the consumer advocates at the Foundation for Taxpayer and Consumer Rights have heard from insurance consumers about their frustrations, concerns and complaints regarding insurance. The two chief concerns and complaints by insurance consumers relate to exorbitant rates and the failure to efficiently and equitably handle a policyholder's or injured victim's claim.

A good example of the former complaint came from a motorist in Pennsylvania:

> I am a consumer who is mandated to carry auto insurance in the state of PA. However, after 15 years of a perfect driving record, and one accident later, my auto insurance rates skyrocketed. After numerous calls to the insurance company, insurance commissioner's office, district attorney, consumer protection agency, I ended up in the same place; no where. All I wanted to know is how does an insurance company determine what an adequate price increase is? Who makes sure they are not overcharging their policy holders? Is it the same people who are salaried by the insurance companies they are suppose to watch over?

An example of the latter comes from New York:

> In 1994 our house in New York was destroyed by a fire that was caused by an accident. On that day we were assured . . . that we would be back in our house in six months, however they have not offered us a settlement that would replace our loss (we were insured for replacement value), and (the insurer) has fought our claim . . . for the past seven and a half years . . .
>
> We have had countless appraisals, and an arbitration that was refused by the insurer. The fact is that My mother paid every month, for thirteen years, to insure that if a catastrophe struck it would be fixed promptly and fully, but our insurer has only offered 2/3's of the replacement cost at any given time, even though we had full replacement coverage. My family has been put through great pain and suffering over this problem, we have in effect been raked over the coals of our burnt out house.

Of course, various iterations of these problems are repeated time and again, not only to consumer protection organizations like ours, but to insurance commissioners and lawmakers throughout the country. Additionally, we often see complaints that merge the two issues. Consumers often complain that an insurer improperly blamed an accident on them, without a proper investigation and then increased their premium. In recent years there has been an upsurge in complaints from homeowners who file a legitimate claim and then are non-renewed by their insurer. Next they find that only very expensive policies are now available to them, because their claim has been filed with a national claims database known as the Comprehensive Loss Underwriting Exchange, or CLUE, which is used by virtually all insurers to discriminate against homeowners with prior claims.

These problems, particularly rate related complaints, are not exclusively the problems of individual consumers of personal lines insurance. This year, Congress and many state legislatures have considered the problem of massive rate hikes for physicians and hospitals purchasing medical malpractice insurance. Unfortunately, the discussion on this issue has focused exclusively on approaches that limit the rights of injured patients, leaving the possibility of regulating insurance company rates (as opposed to victims' rights) virtually out of the picture. Over the years, unregulated medical malpractice insurers have pushed rates wildly up and down, following the trajectory of the broader economy rather than the actual assumption of risk. While the accessibility of insurance in the mid-1990s—even for doctors with terrible records and conduct—went unquestioned, the incredible swing upward in recent years has engendered an angry constituency of doctors who cannot tolerate the vagaries of the unregulated insurance marketplace, even if their fury is misdirected towards the innocent victims of malpractice who try to use the insurance system as it was meant to be used.

On the claims side of the insurance equation, the complaints come from small businesses and associations such as condominium associations as well as individuals. After the very destructive 1994 Northridge, California earthquake, thousands of personal and commercial property insurance claims were low-balled and delayed by insurers. Market conduct exams by the state Department of Insurance indicated

that approximately 50 percent of claimants were mistreated or defrauded to some degree by their insurer. However, those exams, which suggested that insurers owed policyholders more than $200 million in unpaid claims, were quashed by the insurance commissioner, who resigned in disgrace when the public learned of this six years later. The commissioner allowed insurers to avoid penalties and repayment by paying a few million dollars into private foundations controlled by the commissioner. Because the regulatory powers of the Department staff were stymied by the Insurance Commissioner, consumers were left unprotected and underpaid.

In short, the main concerns of insurance consumers are that they pay the right amount for their policy and that they get what they pay for.

Question 2. What lessons regarding insurance regulation do these concerns provide?

Answer. It is our view that these concerns and complaints serve as a strong indication that insurance consumers are best served when the insurance marketplace is well regulated. As the auto insurance policyholder from Pennsylvania notes, all drivers are required by law to purchase the insurance companies' product. Homeowners who have a mortgage are required to purchase insurance, a *de facto* mandate. Indeed, a variety of insurance products have become so integral to the functioning of our economy and consumers' financial lives that it could be said that insurance is akin to a utility in contemporary America.

When a product is mandated or otherwise unavoidable, it is impossible to ensure a competitive marketplace in which the consumer is on an equal playing field with the seller without regulatory intervention. That is, no matter what the insurers charge, a motorist must by auto insurance; a consumer cannot put off buying a policy like they might forgo a new car for another year. Also, a consumer cannot retroactively choose not to buy a policy if an insurer does not pay claims properly; the consumer has already paid for the policy in advance.

As such, we believe that some of the assumptions about delivering consumer protections must be analyzed. You state that "we need to weigh the value of protecting consumers against abusive practices, as well as the desire to allow consumers to obtain the best prices possible for products, stemming from free competition among insurance providers and the absence of overly burdensome regulations."

First, the "best" insurance premiums do not stem from free competition. As we have learned in California and throughout the nation, so-called free competition, or unfettered markets, led to the incredibly volatile and high rates of the insurance crises of early 1970s and the mid-1980s. Second, we are wary of language such as "overly burdensome regulations" because, while we see plenty examples of inefficient and ineffective regulation, it is hard for us to identify examples of overly burdensome regulations.

The insurance industry, which is not even subject to anti-trust laws in most states, has been able to undercut most regulation throughout the country, with the notable exception being California. In order to successfully protect consumers from excessive rates and unfair insurer conduct, new laws should be enacted to strengthen the regulatory oversight of insurance companies. As is the case under California's Proposition 103 the burden to justify insurance rates should be on the companies, rather than on the public to contest rates. Further, insurers should be expected to meet stringent standards of conduct with respect to the treatment of claimants.

The real life concerns of insurance consumers continually teach us that, around the country, the products and services provided by insurers are not sufficiently overseen by regulators. They teach us that the price of insurance is of the utmost importance to consumers and businesses and that, because insurance is a service we pay for in advance, vigilant regulation is essential to ensure that companies fulfill their obligations to consumers.

As we describe in our full testimony, the stringent regime of California's Proposition 103 provides the best example of regulatory efficacy in the Nation. California has successfully regulated insurance rates for 15 years, since the enactment of Proposition 103. The effect of regulation has been to lower rates for consumers while maintaining a healthy and profitable marketplace for insurers. Our full testimony explains in greater detail that insurers' profits in California over the past ten years have been higher than the national average. That tells us that insurance regulation not only protects consumers from unjustifiable premiums, but it also protects insurers from errant and risky practices.

I hope these responses assist you as you look for ways to improve insurance consumer protections. Thank you for considering our views.

RESPONSE TO WRITTEN QUESTION SUBMITTED BY HON. OLYMPIA J. SNOWE TO THOMAS AHART

Question. In your prepared testimony you provided a proposal for the licensing of insurers, insurance agents, and brokers, under which each insurer, agent or broker would be subject to one state regulator for licensing determinations, solvency regulations, financial audits, corporate transaction reviews, and corporate governance requirements. You also propose that state regulators would be limited to 30-day reviews of proposed insurance policies, and states would be prohibited from enforcing requirements for prior rate approvals for insurance coverage sold in a "competitive" marketplace. Finally, you suggest that state regulators should be limited in their ability to conduct examinations. At a time when we hear so many concerns expressed by consumers that they are overwhelmed by the complexity of the insurance products offered to them, and that they are unsure of the solidity of the providers from which they seek to buy products, how would your proposal for a new licensing regime protect the consumer? Would your proposal decrease the ability of regulators to adequately examine new and complicated products, at the same time you were reducing the ability of regulators to go in and examine insurance providers or agents that might be behaving in an unethical manner?

Answer. There is near universal consensus that insurance regulation must be modernized and reformed, but there are differences of opinion about how best to address the flaws and deficiencies that exist with the current regulatory system. Some support pursuing reforms in the traditional manner, which is to seek legislative and regulatory improvements on an ad hoc basis in the various state capitals. A second approach, pursued by several large international and domestic insurers, would result in the dangerous and unprecedented establishment of full-blown Federal regulation. The Independent Insurance Agents and Brokers of America (IIABA) believe the first option is unlikely to result in the desired results or in achieving greater regulatory uniformity among the states. We also believe the second option would unnecessarily jettison the expertise and experience of state regulators, create confusion among consumers, and exempt federally chartered insurers from the consumer protection framework that exists today at the state level.

In response to the need for reform and because of the deficiencies associated with the approaches outlined above, IIABA has developed a third approach and middle-ground solution. Specifically, we are calling on Congress to use the legislative tools at its disposal to overcome the structural impediments to reform and ultimately achieve a more efficient and effective regulatory framework. In other words, we advocate using Federal legislative action to bring about greater consistency and other needed reforms across state lines. In this way, we can assure that insurance regulation will continue to be grounded on the proven skills and experience of state regulators. This pragmatic concept would address many of the legitimate criticisms lodged against the current system and improve and enhance state insurance regulation without replacing it altogether.

Working in conjunction with organizations and policymakers interested in this approach, IIABA continues to consider the potential applications of this concept. Although this development process is still underway, there are some areas where our work is more evolved and refined. In order to give you some perspective concerning the possible applications, I have highlighted some of the ways in which this approach could perhaps be implemented, focusing below only on producer licensing and speed-to-market issues.

- *National Licensing Reciprocity*—In the licensing arena, we propose implementing reciprocity on a 51-jurisdiction basis and preempting all non-resident licensing laws that are inconsistent with the GLBA/NARAB standards. By using Congress's preemptive authority, we could provide that a producer licensed in his/her home state may obtain a non-resident license by simply completing the NAIC's uniform application and paying the requisite fee.
- *National Uniformity*—Additional uniformity is necessary in producer licensing, and Federal legislation could be used to establish greater multi-state consistency. Such uniformity standards could address a broad array of issues, including, but not limited to, resident licensing requirements, the licensing cycle and renewal process, entity licensing, the use of the Producer Database, etc.
- *Countersignature Laws and Other Restrictive Barriers*—This type of proposal could also provide for the outright preemption of countersignature laws and similar barriers to effective multi-state commerce.
- *Parameters for Rate and Form Review*—Through the use of preemption, a Federal proposal could establish parameters for the purpose of standardizing and streamlining the review and approval of insurance products. This could be done

on the form side, for example, by making a traditional file-and-use system (with a strict deemer provision, limited to 30 days, and other mandates) the most stringent form of review available to state regulators. Rate regulation could be addressed in similar ways, and IIABA supports using preemption to move to a competitive rating system that would eliminate the traditional review and approval of rates and only require rates to be filed electronically at the time they are introduced in the marketplace.

Your question appears to focus on three aspects of our proposal—the manner in which in would address product regulation, solvency regulation, and market conduct oversight—and I have attempted to address each of these issues below:

- *Product regulation*—Many states regulate the development and introduction of new products into the marketplace in ways that cause significant and unnecessary delays, undermine the forces of competition, and create affordability and availability problems for consumers. We seek to eliminate the unnecessary delays associated with introducing a new product into the marketplace, and we believe that competition plays an important role. Some state insurance departments actually establish the prices that can be charged for insurance products, but IIABA believes that insurers should be free to set their own insurance rates in any market that is competitive. With regard to policy forms, IIABA believes that states should be mandated to take action on a proposed product within 30 days or some similar, reasonable timeframe. States that have enacted similar reforms, including Illinois and South Carolina, have had great success.
- *Solvency regulation*—This is one area of insurance regulation that operates effectively and efficiently, and IIABA's proposal does not interfere with this functional aspect of insurance regulation. State regulators generally do an excellent job in this area. We do, however, have some strong concerns about how solvency regulation and guarantee funds would be affected by proposals calling for Federal regulation.
- *Market conduct oversight*—IIABA strongly believes that market conduct review should be a primary focus for state regulators, and we do not seek to undermine the work being performed in this area. We do not believe the level of scrutiny should be reduced; we simply believe there should be greater coordination among the states and a greater reliance on home state regulators. Today, insurers are often the subject of lengthy, cumbersome, and duplicative market conduct reviews by multiple state regulators. These regulators do not coordinate their exams and do not share or communicate their findings with other states. IIABA simply seeks to improve the process, enhance multi-state coordination, and eliminate exams that are nothing more than unjustified "fishing expeditions."

IIABA believes that solvency regulation and consumer protection are the two most important functions that are performed by state insurance regulators, and we do not intend to undermine these areas in any way. Our proposal, which calls on Congress to use its legislative and preemptive powers to bring about reform and enhanced consistency, does not dislodge consumer protections in any way.

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